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# CA INTERMEDIATE
# AUDIT



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# QUESTION BANK

FOR MAY & SEPTEMBER 2025

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## Test your Understanding

### Question 1

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

**Solution**

An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

### Question 2

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean. During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work.

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Does such a matter fall within scope of audit?

**Solution**

Proper disclosure of financial information is well within scope of audit.

### Question 3

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

**Solution**

Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

**Question 4**

Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.

However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel. The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation.

**Solution**

It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

**Question 4**

The management of Exotic Tours and Travels Limited requests its auditor Raja & Co.to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures. Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

**Solution**

Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.

**Question 5**

CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing.
Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?





**Solution**

He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

**Question 6**

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

**Solution**

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.

**Correct/Incorrect (ICAI SM)**

State with reasons (in short) whether the following statements are correct or incorrect:

(i) The basic objective of audit does not change with reference to nature, size or form of an entity

Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

(ii) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(iii) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.

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Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing. (RTP May'20 + MTP Oct'21) OR

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon." Explain stating clearly how the person conducting this task should take care to ensure that financial statements would not mislead anybody. (MTP Oct'19 + ICAI SM)

**Solution**

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

i) the accounts have been drawn up with reference to entries in the books of account;
ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
iv) the information conveyed by the statements is clear and unambiguous;
v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and





vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

**Question 2**

PACE is proprietorship firm of Mr Abhinav engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 50 crores. It has also availed cash credit limit of Rs. 5 crores from Axis Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches CA Mahesh about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. (MTP Mar'19)

**Solution**

- Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to government authorities for determining tax liabilities.
- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
- An audit may also detect fraud or error or both.
- An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

**Question 3**

M Motors Ltd is a leading Indian automobile manufacturer with many offerings across commercial, passenger and electric vehicles. The Company is pioneering India's electric vehicle transition and enjoys considerable advantage in one of the fastest growing automotive markets.

GR & Associates have been appointed as its statutory auditors for financial year 2022-23. J and K are newly appointed audit assistants in the firm and are part of engagement team constituted for purpose of audit of M Motors Ltd. However, they are confused about what such an audit tends to achieve. They perceive audit as a guarantee against possible errors or frauds in financial statements. Do you agree



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with perception of both the assistants? In this context, outline objectives of an independent audit conducted in accordance with Standards on Auditing. (RTP May'24)

**Solution**

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of Independent auditor and conduct of an audit in accordance with Standards on Auditing" are: -

a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
b. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

An analysis of above brings out following points clearly: -

(1) Auditor's objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error. Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On the basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.

(2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.

(3) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(4) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing.





Therefore, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors. He obtains reasonable assurance.

**Question 4**

CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? (May'22)

**Solution**

Overall Objectives of the Independent Auditor: As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

In the given case of SR Ltd, CA N expressed his opinion on the financial statements of SR Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not.

Therefore, it can be concluded that CA N did not comply with the objective of audit as stated in SA 200.

**Question 5**

CDE Private Limited, a manufacturing company, had made investment in shares of some blue-chip companies. Additionally, it had temporarily deposited some of its extra funds in fixed deposits with a scheduled bank. Dividend from shares amounting to ₹ 1.80 lakhs (net of TDS, TDS = ₹ 0.20 lakhs) and bank interest of ₹ 2.70 lakhs (net of TDS, TDS = ₹ 0.30 lakhs) were credited in bank account of the company. During the year 2023-24, it has also sold some shares resulting in net gain of ₹ 5 lakhs. The company has shown above incomes under head "Other income" for consolidated amount of ₹ 9.50 lakhs in the statement of Profit and Loss. No other information is furnished in the financial statements put up for audit. As the auditor of the company, discuss whether the above situation constitutes "misstatement" in the financial statements of the company. Also state, few examples of misstatements. (MTP Sep'24)

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**Solution**

Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

In the given situation, there is a difference in amount to be recorded as well as in disclosure of a financial statement item from what is required in accordance with applicable financial reporting framework. The company should have recorded gross amount of dividend and interest amounting to ₹ 2.00 lakhs and ₹ 3.00 lakhs respectively in its financial statements in accordance with AS 13. Therefore, amount recorded under head "Other income" should have been for ₹ 10 lakhs (2 lakhs+3 lakhs+5 lakhs).

Further, in accordance with disclosure requirements of Schedule III of the Companies Act, 2013, other income shall be classified in the above situation as: -

a) Interest Income of ₹ 3 lakhs
b) Dividend Income of ₹ 2 lakhs
c) Net gain on sale of investments of ₹ 5 lakhs

Few examples of misstatements are:

- Charging of an item of capital expenditure to revenue or vice-versa.
- Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework.
- Selection or application of inappropriate accounting policies.
- Difference in accounting estimate of a financial statement item visà-vis its appropriateness in applicable financial reporting framework.
- Intentional booking of fake expenses in statement of profit and loss.
- Overstating of receivables in the financial statements by not writing off irrecoverable debts.
- Overstating or understating inventories.

**Question 6**

RST Ltd., a retail company, has set up internal controls requiring all invoices to be stamped and signed by an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises to ensure that only those purchase bills are produced for payment for which goods have been actually received.

During the audit, the auditor finds that two employees - a purchasing manager and an accounts clerk - have worked together to bypass this control, submitting fake invoices that resulted in payments for goods that were never received. You are required to state the objectives of an audit, as per SA 200, when it comes to ensuring the reliability of financial statements? Also explain, why auditor can provide





only reasonable, rather than absolute, assurance that the financial statements are free from material misstatement due to fraud or error in the context of the given situation? (RTP Jan'25)

**Solution**

In conducting audit of financial statements, the overall objectives of the auditor are:

i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the factors such as nature of financial reporting, nature of audit procedures, not in the nature of investigation, timeliness of financial reporting and decrease in relevance of information over time and future events.

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, the auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors. One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

In the context of RST Ltd., the management designed a control requiring that all invoices be stamped and signed by an authorized person in the Goods Receiving Section to confirm receipt of goods. However, collusion between two employees—the purchasing manager and the accounts clerk—allowed them to bypass this control by submitting fake invoices for payment. Collusion is a significant limitation of internal controls, as it overrides controls designed to prevent such fraud.

Conclusion

Given these factors, the auditor cannot provide absolute assurance that the financial statements are entirely free from material misstatements due to fraud or error.

**Question 7** RSTD Day-1

JK Ltd. was having a 'Pager' manufacturing plant and looking at the demand it was of the view that the company will grow continuously in future. But, with the introduction of mobile phones in the market, the plant was shut down completely. The shareholders of the company were of the view that auditor failed

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to perform their duty and have not informed to them about the company's inability to continue its business, otherwise they might not have suffered the loss. List down the factors giving rise to the inherent limitations due to which auditor cannot provide a guarantee that the financial statements are free from material misstatement due to fraud or error. (May'24)

**Solution**

Inherent limitations of audit: The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error.

These fundamental limitations arise due to the following factors: -

(1) Nature of financial reporting: Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(2) Nature of Audit procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence. Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence. Further, fraud may involve sophisticated and carefully organized schemes.

(3) Not in nature of investigation: Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

(4) Timeliness of financial reporting and decrease in relevance of information over time: The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

(5) Future events: Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.





**Question 8**

Nature of financial reporting itself is one of causes of inherent limitations of audit of financial statements. Explain. (MTP May'24)

**Solution**

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Therefore, nature of financial reporting itself is one of causes inherent limitations of audit.

**Question 9**

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. Give one example each for such practical and legal limitations. (MTP May'24)

**Solution**

Example of practical limitation on ability of auditor to obtain audit evidence

An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Example of legal limitation on ability of auditor to obtain audit evidence

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

**Question 10**

A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement. (SM)

**Solution**

It is not a reasonable assurance engagement. It is in nature of investigation.

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**Question 11**

An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance. [SM]

**Solution**

Nature of Audit procedures

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence.

For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

We have already discussed under section on scope of audit that an auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

**Question 12**

The management of Cool Drinks Limited suspects that some employees of the company may be involved in making fraudulent payments to dummy workers at its various plants in the country. Therefore, they are considering appointment of a firm of auditors to conduct audit involving detailed examination of accounts. However, one senior person among Board members, Mr. P, objects to use of word "audit" in proposed assignment. Comment. Also, discuss how audit is different from investigation. (MTP Sep'24)





**Solution**

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose.

For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The objective of audit, on the other hand, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

Facts of Case:

In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of "investigation".

Conclusion:

Therefore, Mr. P is right in objecting the use of word "audit" in the proposed assignment.

**Question 13**

PD & Co., Chartered Accountants, were appointed as the statutory auditors of MR Limited for the financial year 2023-24. MR Limited included the following clause in the appointment letter to the auditors: "The Auditor shall be responsible for detecting the frauds that may happen in the company during the financial year 2023-24." The auditor objected to inclusion of such a clause in the appointment letter. Discuss in the light of scope of audit. [Sep'24]

**Solution**

Scope of Audit in detection of Fraud: In conducting audit of financial statements objectives of auditor, in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

- An audit is not an official investigation into alleged wrongdoing.
- The auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.
- Audit is distinct from investigation.
- Investigation is a critical examination of the accounts with a special purpose.

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- For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
- The scope of audit is general and broad whereas scope of investigation is specific and narrow.

Thus, inclusion of such a clause in the engagement letter is uncalled for and outside the scope of audit.

**Question 14**

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Explain giving examples. (MTP Nov'23 + Nov'22)

**Solution**

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- ✓ Overlooking unusual circumstances.
- ✓ Over generalising when drawing conclusions from audit observations.
- ✓ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

**Question 15**

Truthful Products Private Limited is engaged in trading stationery items. During the year 2023-24, there was a huge fire in one storage location of the company resulting in loss of inventories of ₹ 5 crores. As a result, the operations of the company were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2023-24 itself. There was no change in nature of business of company in relation to the last year.





The draft financial statements of the company reflect following information: (Figures in ₹ crores)

| Particulars | FY 22-23 | FY 23-24 |
|---|---|---|
| Revenue from Operations | 80 | 100 |
| Net profit before tax | 6 | 10 |

CA D who has been the statutory auditor for past three years, has decided to rely upon the same tests of details as performed in previous years. In the given situation what is lacking on part of the auditor? Discuss. (MTP Sep'24)

**Solution**

Maintaining professional skepticism throughout audit is necessary if auditor is to reduce risks of overlooking unusual circumstances and using inappropriate assumptions in determining the nature, time and extent of audit procedures and evaluating results thereof.

Facts of Case:

In the given situation, revenue from operations of the company have increased from ₹ 80 crores to ₹100 crores despite its operations being affected by fire for about two months. Further, despite loss of inventories to the tune of ₹ 5 crores, financial statements reflect increase in net profit before tax from 7.5% in year 2022-23 to 10% in year 2023-24.

Conclusion:

Thus, approach of CA D lacks professional skepticism. In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances.

He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter.

**Question 16** QoTD

The auditor should decide whether relevant information is properly disclosed in the financial statements. Explain with reference to scope of audit. (MTP-1 May'24)

**Solution**

The auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

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- It is done by ensuring that financial statements properly summarize transactions and even recorded therein and by considering the judgments made by management in preparation of financ statements.
- The management responsible for preparation and presentation of financial statements makes ma judgments in this process of preparing and presenting financial statements.
- For example, choosing of appropriate accounting policies in relation to various accounting issues li choosing method of charging depreciation on fixed assets or choosing appropriate method f valuation of inventories.
- The auditor evaluates selection and consistent application of accounting policies by managemer whether such a selection is proper and whether chosen policy has been applied consistently on period-to-period basis.

**Question 17**

Assurance engagements are not restricted to audit of financial statements alone. Discuss. [SM]

**Solution**

Type of assurance engagement

- Audit of financial Statements: Reasonable assurance engagement
- Review of financial Statements: Limited assurance engagement
- Examination of Prospective financial information: Provides assurance regarding reasonability assumptions forming basis of projections and related matters
- Report on controls operating at an organization: Provides assurance regarding design and operati of controls

**Question 18**

An assurance engagement involves a three party relationship. Discuss meaning of three parties in suc an engagement. [SM]

**Solution**

A three party relationship involving a practitioner, a responsible party, and intended users An assuranc engagement involves abovesaid three parties.

Practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessari related to historical financial information.

Responsible party is the party responsible for preparation of subject matter.





Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

**Question 19**

Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information." Explain in detail giving examples. [RTP May-22/24]

**Solution**

It is to be understood that Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information".

- ✓ Remember that Standards on auditing apply in "audit" of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in "review" of historical financial information which is a limited assurance engagement only.
- ✓ "Historical financial information means" information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- ✓ Here, we have to broadly understand that "audit" and "review" are two different terms.
- ✓ Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement.
- ✓ However, "review" is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement.

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

Some examples of Standards on Auditing are :

i) SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
ii) SA 230 Audit Documentation
iii) SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
iv) SA 500 Audit Evidence
v) Revised SA 700 Forming an Opinion and Reporting on Financial Statements

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Examples of Standards on Review engagements are

i) SRE 2400 (Revised) Engagements to Review Historical Financial Statements
ii) SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of Entity

**Question 20**

Kriti, a CA student, has joined articles in a reputed audit firm. She considers audit engagement to be "assurance engagement". Her understanding is that audit engagement is the only kind of assuran engagement in which practitioner gives a written assurance report in appropriate form. However, h friend Somaya, does not agree with her. She is of the view that assurance engagements are r restricted to audit alone. Besides, Somaya also thinks that assurance engagements can also relate matters other than historical financial information. Whose view appears to be correct? State wi reasons. [RTP Sep'24]

**Solution**

Audit engagement is an assurance engagement. However, assurance engagements are not restricted auditing alone. There are other assurance engagements too like review engagements, engagemer providing assurance involving prospective financial information, engagements providing assurance internal controls in an entity.

Assurance engagements provide assurance to users. The difference is of degree.

- Whereas an audit provides reasonable assurance which is a high level of assurance, review provid lower level of assurance as compared to audit.
- There are also assurance engagements which relate to matters other than historical financi information like providing assurance on matters involving prospective financial information a providing assurance on internal controls in an entity.

Prospective Financial Info.

In assurance reports involving prospective financial information, the practitioner obtains sufficie appropriate evidence to the effect that

- ✓ management's assumptions on which the prospective financial information is based are n unreasonable,
- ✓ the prospective financial information is properly prepared on the basis of the assumptions, and
- ✓ it is properly presented, and all material assumptions are adequately disclosed.

Facts of Case

In the given case, Kriti is of the view that audit engagement is the only kind of assurance engagement which practitioner gives a written assurance report in appropriate form whereas is of the view tha assurance engagements are not restricted to audit alone.





Conclusion: Thus, view of Somaya is correct.

**Question 21** QOTD

Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed o enhance the degree of confidence of the intended users other than the responsible party about the utcome of the evaluation or measurement of a subject matter against criteria. In this context, give hree examples of assurance engagements highlighting difference in nature of assurance provided by uch engagements. (MTP Sep'24)

**Solution**

Three examples of assurance engagements are as under :-

a. Audit of financial statements

An audit of financial statements provides reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

b. Review of financial statements

Review provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

c. Examination of prospective financial information

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that

- ✓ management's assumptions on which the prospective financial information is based are not unreasonable,
- ✓ the prospective financial information is properly prepared on the basis of the assumptions and
- ✓ it is properly presented and all material assumptions are adequately disclosed.
- ✓ Such type of assurance engagement provides a moderate assurance.

**Question 22**

Rajul Ltd. engaged an external practitioner CA Rajul to provide assurance on its prospective financial information for the upcoming year, which includes projections for a new product line. The company projected a 15% increase in revenue, estimating total sales of ₹ 75 crore, driven by the expected launch of this new product. Mention the applicable Engagement and Quality Control Standard and the level of assurance that will be provided in the given situation. Also explain how Prospective Financial Information is different from Historical Financial Information. (MTP I Jan'25)

**Solution**



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In the given situation, Standards on Assurance Engagements will be applicable and such type of assura
engagement provides only a "moderate" level of assurance.

In assurance reports involving prospective financial information, the practitioner obtains sufficie
appropriate evidence to the effect that

- management's assumptions on which the prospective financial information is based are unreasonable.
- the prospective financial information is properly prepared on the basis of the assumptions and
- it is properly presented and all material assumptions are adequately disclosed.

"Historical financial information" and "Prospective financial information." The former relates
information expressed in financial terms of an entity about economic events, conditions or circumstanc
occurring in past periods. The latter relates to financial information based on assumptions abo
occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred where
prospective financial information is related to future events.

**Question 23**

KST Limited is engaged in manufacturing business. It appoints CA T to provide it an assurance report
its financial statements prepared on the basis of historical financial information. The characteristic
such an engagement is that it involves gathering of sufficient appropriate evidence on basis of whi
limited conclusions can be drawn up by practitioner. Identify type of engagement. Which are two oth
features of such an engagement? [MTP May'24]

**Solution**

As given above, the engagement involves gathering of sufficient appropriate evidence on the basis
which limited conclusion can be drawn up. It is a limited assurance engagement like review.

Other two features of such type of engagement are: -

1. It provides lower level of assurance than reasonable assurance engagement.
2. It performs fewer procedures than reasonable assurance engagement.

**Question 24**

"Choosing of appropriate accounting policies in relation to accounting issues is responsibility
management". Do you agree? Discuss duty of auditor, if any, in relation to accounting policies. [SM]

**Solution**

Choosing of appropriate accounting policies is responsibility of management.

The auditor evaluates selection and consistent application of accounting policies by management;





whether such a selection is proper and whether chosen policy has been applied consistently on a period-
o-period basis.

**Case Study 1**

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai. They have cleared
CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of
hem are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started
ttending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been
ble to join Live Coaching Classes yet as she was away on a holiday with her parents. However, she plans
o catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They
iscussed many things regarding its nature, scope, benefits and other general practical issues. Goreti
as regular in keeping track of audited results of companies being published in leading newspapers. Her
iew was that audited financial statements of companies give 100% guarantee to different stake holders.
t is the main reason behind so much reliance upon auditing. But she could not understand why wrong
oings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every
ransaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of
he view that audited financial statements are not a guarantee against probable wrong doings in financial
atters of the companies.

ot to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something
his own.

ased on above, answer the following questions: -

1. Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?
   (a) It provides reasonable assurance meaning a moderate level of assurance.
   (b) It provides reasonable assurance meaning a low level of assurance.
   (c) It provides reasonable assurance meaning a high level of assurance.
   (d) It provides reasonable assurance meaning an absolute level of assurance.
2. Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do soz?



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(a) Yes, he can do so. It is necessary to obtain audit evidence.
(b) Yes, he can do so. There are express rights given to him in this respect.
(c) No, he cannot do so. He can only request for providing him with necessary information and docume
But it cannot be forced by him.
(d) No, he cannot do so. He has no right of seeking information and documents. Therefore, question
forcing does not arise.

**3. Ali had listened in one of the classes that audit covers all aspects of an entity and conclud that each and every transaction of entity is verified by auditor. Goreti also seemed to be agreement with him but she was of the view that besides this, it also meant that audit should so organized to cover all areas of an entity. Which of following statements is appropriate in t regard?**
(a) Only view of Ali is correct.
(b) Only view of Goreti is correct.
(c) Views of both Ali and Goreti are correct.
(d) Views of both Ali and Goreti are incorrect.

**4. All of them also discussed about benefits of auditing. Which of the following is not a like benefit of auditing?**
(a) Since auditing is connected to future events, audited information can be easily relied upon by use
(b) Errors or frauds may be discovered during audit.
(c) Government authorities can make use of audited accounts for different purposes.
(d) It can help in bringing out deficiencies in maintenance of financial records.

**5. Goreti told her friends that she had read a news report about how a company had misled i auditors by producing some fabricated documents. Which of following statements seems to appropriate in this regard?**
(a) It was wrong on the part of auditor to rely upon fabricated documents. He must have discover it as the same falls within the scope of his duties.
(b) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot anything in the matter. He has to report on the basis of documents provided to him. He has no du in this regard.
(c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discoveri genuineness of documents. Hence, management consisting of dishonest persons may have led h to rely upon fabricated documents deliberately.
(d) Management cannot mislead auditor due to high level of knowledge and expertise possessed by hi The above is an outlier case-one of the rare odd cases.





Solution 1. (c) 2. (c) 3. (d) 4. (a) 5. (c)

**Case Study 2**

Me and You Private Limited has been newly incorporated. The plant of the company has recently started roduction with the help of funds provided by a bank for purchase and installation of machinery. Further, he company is also utilizing working capital credit facilities from the same bank for meeting its day to lay working capital requirements like for purchase of raw materials, labour payment etc. However, just ithin six months of its operations, the management feels that working capital funds are inadequate and ituation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working apital credit facilities. The bank manager is insisting upon financial statements of the company for half ear along with report providing assurance in this respect duly signed by Chartered Accountant as audit s far away. It also requires projected financial statements for coming years along with a report from A providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing ssurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

ssume, in above case, the company only provides trial balance, financial statements in draft/preliminary orm along with accompanying records for the relevant half year to CA P and requests him to provide uly signed financial statements with a report for mutually agreed professional fees.

**. Management of company has engaged CA P to issue a duly signed report for half year, as eferred to in last para of case study. Which of the following standards, if any, issued by ICAI e relevant for CA P?**
(a) Standards on Review Engagements
(b) Standards on Auditing
(c) Standards on Related Services
(d) There are no standards for issuing report in such situation.

**. Which of the following statements is MOST APRROPRIATE in given case situation?**
(a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.
(b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.
(c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

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(d) The responsibility of preparation of financial statement is of company's management. CA P can assist management in preparation of financial statements of the company. However, he can issue review report.

**3. In the above said scenario for issuance of signed financial statements for half year by CA as discussed in last para of Case Study, identify the MOST APPROPRIATE statement: -**

(a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.
(b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.
(c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.
(d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report such type of engagement.

**4. The banker of company has also requested for projected financial statements for coming ye along with a report from CA regarding these projections to consider request of management. Wh of the following standards issued by ICAI are relevant for CA P in such a situation, if any?**

(a) Standards on Review Engagements
(b) There are no standards for issuing such type of reports.
(c) Standards on Related Services
(d) Standards on Assurance Engagements

**5. Suppose CA P also accepts work of issuing projected financial statements with a report to signed by him. The management has projected turnover of ₹100 core for the next year, ₹1 crore & ₹200 crore for following years respectively as compared to present turnover of ₹25 cr in current half year. Identify the MOST APPROPRIATE statement in this situation: -**

(a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.
(b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnov and its consistency with actuals.
(c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its prop presentation to banker.
(d) CA P has to satisfy himself regarding reasonableness of assumptions underlying project turnover, its consistency with actuals, disclosure and presentation.

**Solution** 1. c 2. c 3. c 4. d 5. d

## Individual MCQs

**1. Which of the following is not an advantage of audit?**

(a) It provides high quality financial information.
(b) It acts as a moral check on employees.
(c) It enhances risk of management bias.
(d) It helps in safeguarding interests of shareholders.





**. Which of the following is NOT TRUE about an assurance engagement?**

(a) It relates to providing assurance about historical financial information only.
(b) The practitioner obtains sufficient appropriate evidence.
(c) There is some information to be examined by practitioner.
(d) A written assurance report in appropriate form is issued by practitioner.

**. Which of the following is TRUE about Engagement Standards?**

(a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.
(b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.
(c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.
(d) Engagement standards ensure savings in resources of clients.

**. Consider following statements in relation to "Limited assurance engagement":-**

**tatement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.**
**tatement II - Review of interim financial information of a company is an example of limited ssurance engagement.**

(a) Statement I is correct. Statement II is incorrect.
(b) Both Statements I and II are correct.
(c) Both Statements I and II are incorrect.
(d) Statement I is incorrect. Statement II is correct.

**. Which of the following is TRUE about Standards on auditing?**

a. These deal mainly with voluntary responsibilities of auditors.
b. These deal mainly with mandatory responsibilities of auditors.
c. Their sole purpose is to help government authorities in augmenting revenues.
d. These deal mainly in carrying out audit according to legal provisions.

**Professional skepticism includes-**

a. Overlooking unusual circumstances.
b. Using inappropriate assumptions in determining extent of audit procedures.
c. Over generalising when drawing conclusions from audit observations.
d. Being vigilant to conditions that might indicate possibilities of fraud.

**nswers** 1. (c) 2. (a) 3. (c) 4. (d) 5. (b) 6. d

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## SA 210: Agreeing the Terms of Audit Engagement

### Test your Understanding

**Question 1**

Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He read somewhere that engagement letter issued by auditor to client also includes expected form content of the auditor's report. He was at a loss to understand how could an auditor include form content of the report beforehand. Try to help Chirag by making things clear to him.

**Solution**

Engagement letter includes reference to expected form and content of audit report. It merely sta that auditor would provide opinion in this form. However, engagement letter also includes statement t the form and content of report may need to be amended in the light of audit findings. Therefore, i light of audit findings, auditor needs to give a modified opinion, he shall do so.

**Question 2**

The management of an entity feels that it is not necessary for it to give in writing explicitly to auditor that it understands its responsibilities for preparation of financial statements in accorda with applicable financial reporting framework. Discuss, whether, it is necessary for the management do so. In case management refuses, why should an auditor not accept the proposed engagement?

**Solution**

It is necessary for management to give in writing explicitly to the auditor that it understands responsibilities for preparation of financial statements in accordance with applicable financial report framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with manageme

Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engageme

a. If the auditor has determined that the financial reporting framework to be applied in preparation of the financial statements is unacceptable or
b. If the agreement of management is not obtained on matters relating to understanding responsibility of management on preparation of financial statements, internal controls preparation of financial statements, providing access to all information to auditor and unrestrict access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary management is not willing to accept its responsibility for preparation of financial statements accordance with applicable financial reporting framework. An audit is conducted on this basic prem according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by audit is necessary.





### MCQs

**Which of the following is not necessary to establish preconditions for an audit?**

a. Acceptability of financial reporting framework.
b. Acknowledgment of cooperation from management in designing audit procedures.
c. Acknowledgment from management of providing access to persons within company.
d. Acknowledgment of management in understanding its responsibility for preparation of financial statements.

**Ans.** (b)

### Correct/Incorrect

. The audit engagement letter is sent by the client to auditor.

Incorrect: Audit engagement letter is sent by the auditor to his client.

### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Mr. J is an articled clerk with a big Chartered Accountants' firm. He is a part of the engagement team which is conducting the audit of a company for the first time. They are assigned with the work of preparing the draft audit engagement letter. Mr. J is not sure how to go about with this work. Explain what is Audit Engagement Letter and what are its contents? [Sep'24]

OR

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement. Who gives engagement letter to whom and what is included in such a letter? [MTP May'24]

OR

M Paras has accepted audit of financial statements of an entity. According to the Standards on auditing, the auditor is required to send an audit engagement letter to the entity. What are the key areas that should be included in the audit engagement letter? Under what circumstances is the auditor not required to record the terms of engagement in such a written agreement? [MTP Jan'25]

**Solution**

Audit Engagement Letter: The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement are recorded in a letter or other the suitable form of written agreement.

Such an agreement is known as Audit Engagement Letter.

- The audit engagement letter is sent by the auditor to his client.
- It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

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Audit Engagement letter includes: -

1. The objective and scope of the audit of the financial statements
2. The responsibilities of the auditor
3. The responsibilities of management
4. Identification of the applicable financial reporting framework for the preparation of the financ statements and
5. Reference to the expected form and content of any reports to be issued by the auditor an statement that there may be circumstances in which a report may differ from its expected fo and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor ne not record them in a written agreement, except for the fact that such law or regulation applies, a that management acknowledges and understands its responsibilities.

**Question 2**

On recurring audits, the auditor shall assess whether circumstances require the terms of the audi engagement to be revised and whether there is a need to remind the entity of the existing terms of th audit engagement. The auditor may decide not to send a new audit engagement letter or other writte agreement each period. Explain the factors an auditor considers to be appropriate to revise the term of the audit engagement or to remind the entity of existing terms. [RTP May-21]

**OR**

A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210. [SM]

**Solution**

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period.

However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.





- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

**Question 3**

Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre conditions for an audit. [Dec-21 & RTP May-21]

**Solution**

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

a. Determine whether the financial reporting framework is acceptable; and
b. Obtain the agreement of management that it acknowledges and understands its responsibility:
   i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;
   ii) For the internal control as management considers necessary; and
   iii) To provide the auditor with:
      - Access to all information such as records, documentation and other matters;
      - Additional information that the auditor may request from management for the purpose of the audit; and
      - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

**Question 4**

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. Explain the circumstances which may contribute towards a request from the client for the auditor to change the engagement. [RTP Nov-22 + Nov-22]

**Solution**

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from

- a change in circumstances affecting the need for the service,
- a misunderstanding

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- a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

**Question 5**

CA X has been offered audit of financial statements of TDK Industries, a partnership firm. Prior to accepting proposed offer, he insists upon obtaining an agreement of management regarding acknowledgment of its responsibility of having a proper process in place to ensure that financial statements prepared are free from material misstatements. However, management is of the view that it is auditor's duty to detect material misstatements in financial statements and such an insistence by auditor is totally uncalled for. Whose view is proper? Also discuss reasons for arriving at your conclusion. What should be likely proper course of action for CA X in above situation? [RTP May'24]

**Solution**

SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those with governance, are present.

The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

A. Establishing whether the preconditions for an audit are present and
B. Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

One of the preconditions for an audit is to obtain the agreement of management that it acknowledges and understands its responsibility for preparation of financial statements and for such internal control as is necessary to enable preparation of financial statements that are free from material misstatements.

Facts of Case

In the given situation, CA X is insisting only upon obtaining agreement of management regarding acknowledgment of its responsibility for internal control to enable preparation of financial statements that are free from material misstatements in accordance with SA 210. Design, implementation and maintenance of internal control to ensure preparation of reliable financial statements that are free from material misstatements is management's responsibility. He is insisting on obtaining agreement of management regarding acknowledgment of its responsibility.

Conclusion

Therefore, CA X's view is proper. In case management does not provide such agreement acknowledging its responsibility, the auditor shall not accept proposed audit engagement unless required by law or regulation.



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**Question 1**

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

**Solution**

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

**Question 2**

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

**Solution**

"Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

**Question 3**

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

**Solution**

When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment.

Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

**Question 4**

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

**Solution**

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

**Question 5**

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

**Solution**

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.

**Question 6**

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

**Solution**

Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.



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Facts of Case

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering.

Conclusion

Therefore, proposed offer should not be accepted.

**Question 7**

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

**Solution**

SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

Facts of Case

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fintech" sector. The firm does not have trained personnel to carry out these audits.

Conclusion

Hence, offer for these audits should not be accepted.

**MCQs**

**1. Identify the most appropriate statement: -**

(a) SA 220 applies at the level of firm.
(b) SQC 1 is premised on the basis that firm is subject to SA 220.
(c) SA 220 is premised on the basis that firm is subject to SQC 1.
(d) SA 220 applies to all engagements.

**2. Which of the following is not a fundamental principle governing professional ethics?**

(a) Professional competence and due care
(b) Integrity
(c) Objectivity
(d) Safeguards to independence

3. Identify the most appropriate statement in context of SQC 1.
(a) Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.
(b) Engagement files should be completed before date of auditor's report in case of audit engagements.
(c) Engagement files should be completed in not more than 60 days after completion of an engagement.
(d) Engagement files should be completed on date on which audit report is signed in case of audit engagements.

1. c 2. d 3. a

## Case Study

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of "weather-forecasting". Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm choses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

1. Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?
(a) The above discussion is irrelevant in context of proposed offer.
(b) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.



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(c) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.
(d) The matter is too trivial to be reported by CA Sukanya to other partners of firm.

2. Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.
(a) Self-interest threat
(b) Familiarity threat
(c) Self-review threat
(d) Advocacy threat

3. The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?
(a) Objectivity
(b) Professional behaviour
(c) Professional competence and due care
(d) Integrity

4. Das & Co. have failed to advise the company regarding audit of consolidated financial statement Which fundamental principle of professional ethics is violated by Das & Co.?
(a) Professional behaviour
(b) Integrity
(c) Objectivity
(d) Professional competence and due care

5. Which of the following statements is most appropriate regarding providing offer of work services by auditors to the company?
(a) Such offer may create a self-review threat.
(b) Such offer may create an advocacy threat.
(c) Such offer does not constitute any threat.
(d) Such offer may create self-review and advocacy threats

1. c 2. d 3. b 4. d 5. a

**Question 1**

Briefly outline how principles-based approach differs from rules-based approach to ethics. [SM]

**Solution**

Principles Based Approach VS Rules Based Approach

Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

**Question 2**

"SA 220 is premised on the basis that the firm is subject to SQC 1". What do you understand by given statement in context of audit quality? [RTP May'24]

**Solution**

Audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is responsibility of auditor to maintain high audit quality.

SQC 1 and SA 220 both deal with quality control. SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

Based upon quality control system of firm established in accordance with requirements of SQC 1, quality control policies pertaining to audit engagements are decided by engagement teams. Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement.





**Question 3**

SQC 1 requires assumption of leadership responsibilities for quality within firm. Are such leadership responsibilities required for audit engagements only? Who assumes such leadership responsibilities within firm? How it is important for audit quality? [MTP I Sep'24]

**Solution**

SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Therefore, such leadership responsibilities are required for all engagements and not for audit engagements only.

Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control.

The example set by firm's leadership encourages an inner culture that recognizes high quality audit work.

Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

**Question 4**

An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility? [MTP I May'24 + SM]

**Solution**

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

i) Performing work that complies with professional standards and regulatory and legal requirements;

ii) Complying with the firm's quality control policies and procedures as applicable;

iii) Issuing auditor's reports that are appropriate in the circumstances; and

iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

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**Question 5**

CA Tripad (engagement partner) based at New Delhi is external auditor of Lap of Nature, a firm, since last three years. The firm is engaged in business of providing tourism services including holiday packages to its club members. It has also provided auditor including his team members free holiday for a week every year in one of its premium resorts in Ooty in the State of Tamil Nadu. The company has also booked free air travel for engagement team members during all these years. Discuss why Chartered Accountant is not acting ethically, How are familiarity threats created in above situation?

[MTP-1 May'24]

**Solution**

The firm is providing free hospitality to engagement team members including engagement partner. In such circumstances, fundamental principles governing professional ethics are violated. Such acts of free hospitality are capable of impairing objectivity of auditor.

The situation given in the question signifies that auditors have formed relationships with client where they may end up being too sympathetic to the client's interests.

Due to free hospitality enjoyed by engagement team members, they may take a sympathetic view to issues which may have arisen during course of audit. In this way, familiarity threats are created in the situation.

**Question 6**

A professional accountant is expected to comply with the fundamental principles of professional ethics at all times. Explain which fundamental principle governing professional ethics is violated in the following situations?

1. A chartered accountant in practice accepted the appointment as an auditor of a firm in which his sister was a partner.
2. A chartered accountant in practice was approached by his friend to seek some insider information about a company, which was a client of the chartered accountant. He could not refuse his friend's request.
3. A chartered accountant in practice failed to inform his client about the change in laws applicable to his client. [May'24]

**Solution**

Fundamental Principles:

(1) Objectivity: The principle of objectivity requires that a professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity. Objectivity principle will be violated in the given situation where a





chartered accountant in practice accepted the appointment as an auditor of a firm in which his sister was a partner.

(2) Confidentiality: Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality principle will be violated in the given situation where a chartered accountant in practice could not refuse his friends requested to seek some insider information about a client company of the chartered accountant.

(3) Professional Competence and Due care: A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards. Professional Competence and Due Care principle will be violated in the situation where a chartered accountant in practice failed to inform his client about the change in laws applicable to his client.

**Question 7**

CA P is a professional accountant in service. In terms of employment and professional relationships with employer he has to be alert to the possibility of inadvertent disclosure of any information outside the employing organization. However, in view of disclosure required by law, CAP had to divulge the information and documents as evidence in course of legal proceedings. Whether CA P has violated any fundamental principle governing professional ethics in this case? Explain. [Sep'24]

**Solution**

Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example,

when it is required by law,

when it is permitted by law and is authorised by the client or employer or

there is a professional duty or right to disclose when not prohibited by law.

Facts of case

In the given situation, CA P, who is a professional accountant in service, and in terms of employment and professional relationships with the employer he is alert to the possibility of inadvertent disclosures of

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any information outside the employing organization. However, CA P had to divulge the information and documents as evidence in the course of legal proceedings and same was required by law.

Conclusion

Therefore, CA. P will not be held responsible for violation of fundamental principle of "Confidentiality" governing professional ethics.

**Question 8**

CA N, engagement partner of LPS & Associates, is planning for audit of a large company. As part of preliminary engagement activities being performed in this regard, he wants to ensure that compliance with independence requirements is adhered. How shall he form a conclusion that audit firm complies with independence requirements? [RTP Sep'24]

OR

How does SQC 1 ensure that independence in engagements is not breached by an audit firm? [SM]

**Solution**

The engagement partner, CA N shall form a conclusion on compliance with independence requirements that apply to the audit engagement.

In doing so, CA N shall: -

i) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence

ii) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and

iii) Take appropriate action to
- ✓ eliminate such threats or
- ✓ reduce them to an acceptable level by applying safeguards, or,
- ✓ if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation.

The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

**Question 9**

The Chartered Accountant has a responsibility to remain independent by taking into account the context which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard. [RTP May-21]

OR





CA Sudhakar has been appointed as the auditor of AMRO Ltd. Before accepting the appointment, he learns that his cousin, who held shares in the company and recently passed away without children, named him as the nominee for these shares, which have substantial value. Although holding such shares through a distant relative does not violate legal provisions or affect his independence, this unexpected inheritance places him in a dilemma. Advise CA Sudhakar on how he should deal with this situation and safeguard his independence. [RTP Jan'25]

**Solution**

In the given situation, holding shares by CA Sudhakar involves financial interest in the company and is in nature of self-interest threat. Though he has come to hold shares due to nomination made by his distant relative before accepting the appointment.

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level.

To address the issue, the following guiding principles are to be applied: -

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards measures need to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Considering above, holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence. Therefore, CA Sudhakar should take steps to eliminate the threat by selling shares immediately before accepting the appointment and in the absence of same, he should not accept the appointment as an auditor.

**Question 10**

As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new

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client. Explain stating clearly the information that would assist the auditor in accepting and continuing of relationship with the client.

**Solution**

The following information would assist the auditor in accepting and continuing of relationship with the client:

(i) Integrity of principal owners

(ii) competence of engagement team and consideration of necessary capabilities including time and resources

(iii) Compliance with relevant ethical requirements

(iv) Significant matters arisen during current or previous audit engagement and their implications assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate.

**Question 11**

ABC & Associates, an audit firm, has been approached by a prospective company client that has been in business for about 10 years to conduct an audit of its financial statements. Before accepting the audit engagement, the firm wants to access the integrity of prospective client. With regard to the assessment of integrity, which matters should be considered by the audit firm? [RTP Sep'24]

**Solution**

With regard to the integrity of a client, matters that ABC & Associates should considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.

**Question 12**

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Discuss the personnel issues addressed by such policies and procedures. [MTP Oct-19]



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**Solution**

Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc.

There should be emphasis on the continuing professional development of firm's personnel.

**Question 13**

CA M is the engagement partner of the firm M/s Y2Z LLP and he is auditing the financial statements of a listed entity ABC Ltd. The audit firm has determined that an engagement quality control review is required for this assignment. Discuss the responsibilities of CA M as an engagement partner for engagement quality control review as per SA-220.

**Solution**

As per SA 220, for audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

i) Determine that an engagement quality control reviewer has been appointed.

ii) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

iii) Not date the auditor's report until the completion of the engagement quality control review.

iv) If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

**Question 14**

SQC 1 dwells upon engagement quality control review (EQCR) as part of system of quality control in a firm. Why is such a review required? For which type of engagements EQCR is mandatory? What should be approach of firm for engagements for which EQCR is not mandatory? [MTP May'24]

**Solution**

- Significant judgments made in an engagement should be reviewed by an engagement quality contr reviewer for taking an objective view before the report is issued.
- Engagement quality control review is mandatory for all audits of financial statements of liste entities.
- In respect of other engagements, firm should devise criteria to determine cases requiri performance of engagement quality control review.

"If there is no struggle, there is no progress"

## Test Your Understanding

**Question 1**

MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?

**Solution**

Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary.

Facts of Case: In the stated case, company is involved in technical and complex operations.

Conclusion: Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.

**Question 2**

CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures. Is approach of CA Kartik proper?

**Solution**

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit.

Facts of Case: In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls.

Conclusion: Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.

**Question 3**

CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of





material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA-300?

**Solution**

These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of inhouse legal counsel is to identify and assess risk of material misstatement. Such planned risk assessment procedures are included in audit plan in accordance with SA-300.

**Question 4**

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

**Solution**

Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company.

Non-compliance of the same can have implications in form of civil and criminal liabilities. Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.

**Question 5**

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc.

During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?

**Solution**

Attitude of Rohit is not proper. The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

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## MCQs

1. Which of the following is not considered in planning an audit generally?
(a) Understanding of legal and regulatory framework of an entity
(b) Need to consider determination of materiality
(c) Evaluating audit evidence
(d) Need to consider involvement of expert

2. Which of the following is true about audit plan?
(a) Once an audit plan has been finalized for an engagement, changes cannot be made to it.
(b) Audit plan includes scope, timing and direction of planned risk assessment procedures.
(c) Changes in audit plan cannot lead to change in audit strategy.
(d) Audit plan has to be documented by auditor.

3. Which of the following is not included in an audit programme normally?
(a) Extent of checking
(b) Date of checking
(c) Nature or type of procedure
(d) Planning of risk assessment procedures

4. Which of the following is not an advantage of an audit programme?
(a) It acts as a guide for audit of coming years.
(b) It fixes responsibility of assistants.
(c) It serves as a shelter for assistants.
(d) It serves a proof of work done by auditor.

5. Which of the following is most important principle for formulating an audit plan?
(a) Gaining knowledge of client's workforce
(b) Gaining knowledge of client's business
(c) Gaining knowledge of client's vendors
(d) Gaining knowledge of tax laws applicable to client

**Answers** 1. (c) 2. (d) 3. (d) 4. (c) 5. (b)

### Case Study

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The appointment is subsequently accepted by her.





She is also taking into account number and location of branches of the company, requirements of Schedule III of Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

1. Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?
(a) She is establishing audit strategy.
(b) She is conducting preliminary engagement activities.
(c) She is designing audit plan.
(d) She is checking her compliance of ethical requirements.

2. Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -
(a) Developing audit plan
(b) Establishing overall audit strategy
(c) Designing audit programme
(d) Designing risk assessment procedures

3. Taking into account description of planned inquiry and visit, which of the following statements is TRUE?
(a) Planned inquiry and visit fall in area of audit strategy.
(b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.
(c) The said description is not related to audit planning.
(d) Planned inquiry and visit fall in scope of audit programme.

4. What is detailed set of instructions given to assistants in engagement team known as?
(a) Audit guidelines
(b) Audit plan
(c) Audit Programme

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(d) Audit Procedures

**5. The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?**

(a) She should ignore this information as audit has already begun.
(b) She should modify earlier set of instructions.
(c) She should leave the matter to wisdom of engagement team.
(d) She should put the ball in court of management as she was not provided with complete information earlier.

**Answers** 1. (b) 2. (b) 3. (b) 4. (c) 5. (b)

**Correct/Incorrect (ICAI SM)**

1. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.

Correct: Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

2. Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.

Incorrect. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan

3. Planning is a discrete phase of an audit

Incorrect. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures

4. A detailed Audit Programme once prepared for a business can be used for all business under all circumstances. [+MTP Nov-21]





Incorrect. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable

5. The audit plan is more detailed than the overall audit strategy

Correct. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

**Past Exams/RTPs/MTPs/SM Questions**

**Question 1**

Surya and Chand Ltd is a manufacturing company engaged in the production of miscellaneous electrical goods. Trilochan and Co. has been appointed as the auditors to carry out its audit. Auditor thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also, Adequate planning benefits the audit of financial statements in several ways. Analyse and Advise explaining the benefits of adequate planning.

(MTP May'24 + RTP Nov'21 + Nov'18 + RTP May'18)

**Solution**

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan.

Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

**Question 2**

CA E is auditor of LM Ltd. Before commencing with current year's audit, he initiated planning for the audit. Planning includes the need to consider certain matters, prior to the identification and assessment of the risk of material misstatements. Enumerate such matters. [May'24] **OR**

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Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes the need to consider certain matters prior to the auditor's identification and assessment of the risks of material misstatement. Explain clearly stating those matters also. (MTP May'24 + RTP May'21/19)

**Solution**

In the context of recurring audits, as per SA-300, "Planning an Audit of Financial Statements", Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

**Question 3**

Preliminary engagement activities include certain activities to be performed by an auditor while planning an audit. Discuss such activities briefly. How performing such activities assists an auditor?

[RTP May'24 +SM]

**Solution**

Preliminary engagement activities include following activities: -

a) Performing procedures regarding the continuance of the client relationship
b) Evaluating compliance with ethical requirements, including independence
c) Establishing an understanding of terms of engagement

Performing preliminary engagement activities assists auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.



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**Question 4**

You have been appointed as an auditor of MKP Ltd. for the first time. Discuss briefly, the factors to be considered by you while establishing overall audit strategy. [MTP May-22]

**OR**

"In establishing the overall audit strategy, the auditor shall, among other considerations, ascertain the nature, timing and extent of resources necessary to perform the engagement" Explain those considerations in detail. [MTP Oct-21]

**Solution**

As per SA-300, "Planning an Audit of Financial Statements", the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

In establishing the overall audit strategy, the auditor shall:

i) Identify the characteristics of the engagement that define its scope;
ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

**Question 5**

Subodh has recently joined an audit firm as an articled clerk. He was in process of assembling audit working papers in audit file of Cop Limited, as per the instructions of his senior. While assembling, he noticed following working paper in audit file: -

Timing of Audit Activities

| Activity | Expected Timing |
|---|---|
| Audit Planning | July 1, 2023 - July 5, 2023 |
| Audit Field Work | July 10, 2023 - August 20, 2023 |
| Review by Manager | August 21, 2023 |
| Review by Engagement Partner | August 22, 2023 - August 25, 2023 |
| Review by EQCR | August 26, 2023 - August 27, 2023 |
| Response on Audit Memo | August 28, 2023 |
| Review by Partners – internally post response on audit memo | August 29, 2023 |
| Review by EQCR | August 30, 2023 |
| Finalization of Audit Report and Financial Statements | September 01, 2023 - September 02, 2023 |

| Issuance of Audit Report and Financial Statements | September 03, 2023 |
|---|---|

The above working paper lists certain factors which are considered by the auditor while establishing audit strategy. Explain how these considerations highlighted in above working paper could have helped the auditor? [MTP Sep'24]

OR

In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement.

[MTP Nov-21/Apr-23/May'24]

**Solution**

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. One of the factors to be taken into consideration while establishing audit strategy relates to ascertaining of reporting objectives of engagement to plan the timing of the audit and the nature of the communications required.

Some of the instances are given under:

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

In the given case, working paper highlights that auditor has taken into account expected timelines to plan the audit and nature of the communications required.

Since the working paper relates to the statutory audit of a company, the ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications.

**Question 6**

B Ltd. is a company manufacturing bed-sheets and pillow covers. They have appointed M/s C & Co., Chartered Accountants, as their auditors. The auditor is establishing audit strategy with his team members. As the work progressed, they came to know that the company has diversified its business and now they are also planning to manufacture wooden furniture. The auditor, in his professional judgement,





considers this to be a significant factor in directing the engagement team's efforts. Give examples of factors that, in auditor's professional judgement, are significant in directing the engagement team's efforts. [May'24]

OR

Lotus Ltd., a rapidly growing manufacturing company, appointed Ridhi & Co., as statutory auditor. The engagement team of Ridhi & Co. identified key areas requiring scrutiny, such as revenue recognition, inventory valuation, and related party transactions. Based on his professional judgment, CA Ravi, the engagement partner, directed the engagement team to focus on these critical areas, emphasising the need for detailed testing to ensure accuracy and compliance. Give some examples of the factors need to be considered by CA Ravi for establishing the audit strategy. (MTP 1 Jan'25) OR

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Give three examples to explain the above situation.

[MTP II May'24]

**Solution**

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures helps auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes.

Few examples are listed as under: -

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

**Question 7**

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall audit strategy assists the auditor to determine such matters as for example – the resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters. Explain the other three such matters. [RTP May-20]

OR



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EFG Ltd. has appointed M/s. MN & Co., Chartered Accountants, as the statutory auditors for the year 2024-25. CA N, the engagement partner, completed his risk assessment procedure. However, he is concerned about the management of human resources to be employed to conduct the audit. For this purpose, he wants to establish an overall audit strategy for setting the scope, timing and direction of the audit. Describe how the process of establishment of overall audit strategy will assist him in managing deployment of his human resources for various audit areas. [Sep'24 + MTP May-18]

OR

The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit. Required How the audit strategy would be helpful to the auditor? [SM]

**Solution**

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

i) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
ii) The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
iv) How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

**Question 8**

Engagement Partner CA Hitesh Kapur of Kapur and Associates wanted to develop an audit plan of Sampurna Fabrics Ltd. Discuss the matters to be described in such an audit plan. [RTP May-22] OR

Auditor shall develop an audit plan that includes description of audit procedures. Specify requirements in this regard. [MTP May'24]

**Solution**

The auditor shall develop an audit plan that shall include a description of :





i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

Example

✓ Planning of the auditor's risk assessment procedures occurs early in the audit process.
✓ However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.
✓ In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

**Question 9**

During the audit of ABC Ltd., a medium-sized manufacturing company, the engagement partner is responsible for directing and supervising the work of the engagement team. The team includes both experienced members and several new trainees. Additionally, certain areas of the audit have been identified as high-risk, such as revenue recognition and inventory valuation, due to recent changes in ABC Ltd.'s accounting policies. What factors should the engagement team members consider when determining the nature, timing, and extent of direction, supervision, and review of the engagement team's work? [RTP Jan'25/Nov-22/Nov-21]

**Solution**

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase i



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the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).

- Capabilities and competence of the individual team members performing the audit work.

**Question 10**

Explain what do you mean by documentation of audit plan. Discuss the purpose served by it and also elaborate the tools used by the auditor to reflect the particular engagement circumstances. [RTP Nov-22]

**Solution**

- Meaning: The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.
- Purpose: It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.
- Tools: The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

**Question 11**

CA D is planning an audit of a listed company. List specific documentation requirements in accordance with SA 300 in relation to planning such an audit. How such planning documentation is useful? [MTP Sep'24]

**OR**

The auditor shall document the overall audit strategy, the audit plan and any significant changes made to the overall audit strategy or the audit plan. Explain in detail. [RTP Nov-20/ 18 + MTP Aug-18]

- The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.
- The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.
  - ✓ It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.
  - ✓ The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.
- A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.





Conclusion

CA D, the auditor of a listed company, shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

**Question 12**

"Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy". Explain. [SM]

**OR**

The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard. [Sep'24 + MTP Mar-19]

**Solution**

- Audit strategy sets broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit.
- Audit plan describes how strategy is going to be implemented. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.
- Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.
- The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

**Question 13**

APR & Associates, a Chartered Accountant firm, are appointed as the auditors of Time Ltd. and Bakes Ltd. The volume and nature of business of both the companies are entirely different. CA R is the engagement partner for Bakes Ltd. CA P is the engagement partner for Time Ltd. CA R formulates an Audit Programme for conducting the audit of Bakes Ltd. He suggests CA P to use the same audit programme for Time Ltd. But CA P is of the opinion that this audit programme will not be useful for the audit of Time Ltd.

In light of the above, mention the matters that should generally be considered while preparing an Audit Programme. Is CA P correct in emphasizing for a different Audit Programme for Time Ltd.? [May'24]

**OR**

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While developing an audit programme, the auditor may conclude that relying on certain internal control is an effective and efficient way to conduct his audit. Explain stating clearly the points to be kept in mind while developing an audit programme. [RTP Nov-22]

**Solution**

For the purpose of programme construction, the following points should be kept in mind:

1. Stay within the scope and limitation of the assignment.
2. Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
3. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
4. Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
5. Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
6. Consider all possibilities of error.
7. Co-ordinate the procedures to be applied to related items.

Evolving one audit programme- Not Practicable for All businesses

- ✓ Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others;
- ✓ efficiency and operation of internal controls and
- ✓ the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment.

On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. In view of above mentioned provisions, CA. P is correct in emphasizing for a different audit programme for Time Ltd.

**Question 14**

*Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions apparent in the statements of account produced for audit or based on an appraisal of the accounting records of the client. For example, while auditing a company's inventory, the program may include steps to verify physical stock counts, ownership rights, and valuation. What are the advantages of an audit programme? (MTP Jan'25)*

***Solution***

*The advantages of an audit programme are:*



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- It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a risk of ignoring or overlooking certain books and records. Under a properly framed programme, such risk is significantly less and the audit can proceed systematically.
- The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- It serves as a guide for audits to be carried out in the succeeding year.
- A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

**Question 15**

CA Vikas Jain discussed with his audit team about advantages and disadvantages of audit programme. He explained to his team that –"work may become mechanical" as disadvantage of the audit programme. Discuss explaining the disadvantages of an audit programme. [MTP Apr-22]

OR

Sanjana is of the view that there exist some disadvantages in the use of audit programmes but most of these can be removed by following some concrete steps. Do you agree with her perspective? Comment. [MTP Sep'24 + SM]

**Solution**

The view of Sanjana is appropriate. Some disadvantages are there in the use of audit programmes but most of these can be removed by following some concrete steps.

The disadvantages are: -

i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

iii) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

iv) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by

- imaginative supervision of the work carried on by the assistants;
- the auditor must have a receptive attitude as regards the assistants;
- the assistants should be encouraged to observe matters objectively and
- bring significant matters to the notice of supervisor/principal.

**Question 16**

M/s TP & Co., a firm of Chartered Accountants, is auditor of KSR Ltd. for many years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified? Guide them. [MTP Sep'24 + Dec-21]

**Solution**

The Assistant Engaged – Be Encouraged to Keep an Open Mind: To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.

- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern.
- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.
- He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

In the given case, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the company has diversified.

**estion 17**

s. PP & Co, a firm of Chartered Accountants, has been auditing the books of accounts of KALI Ltd. the past 3 years. The company has recently made some major changes in its business policies. While ing to start the audit for the 4th year i.e. for financial year 2024-25, the audit manager of the





firm, as per the routine practice, handed over the previous years' audit programme as it is to the audit team with the instructions to adhere unfailingly to the said audit programme. Evaluate the decision of the audit manager with reference to the use of audit programme. [Sep'24]

**OR**

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. Explain [RTP May-19]

**Solution**

Periodic Review of The Audit Programme

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions.

Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.

However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc.

So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme.

This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Facts of Case: In the given situation, Ms. PP & Co., a firm of Chartered Accountants has been auditi the books of accounts of KALI Ltd. for the past 3 years and the Company has recently made maj changes in its business policies, therefore, it is very essential to review the audit programme.

Conclusion: Thus, contention of the audit manager to adhere with the instructions of following the s audit programme as per routine practice is not correct.



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**Question 18**

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields. Analyse and explain with the help of examples. [RTP Nov-20]

**Solution**

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

a. Documentary examination,
b. Physical examination,
c. Statements and explanation of management, officials andemployees,
d. Statements and explanations of third parties,
e. Arithmetical calculations by the auditor,
f. State of internal controls and internal checks,
g. Inter-relationship of the various accounting data,
h. Subsidiary and memorandum records,
i. Minutes,
j. Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is 'count'
2. For investment pledged with a bank, the banker's certificate.
3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary.

In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should describe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to circumstances and usage.





**Question 19**

The assistant of CA K is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of "Broad Industries", a partnership firm. The said firm is a GST registered tax payer and is engaged in manufacturing of packing boxes from a special type of paper taxable under GST. Help him by drafting a sample audit programme for purchases. [RTP May'24]

**Solution**

Name of Concern : Broad Industries
Financial Year : 20XX-XX
Prepared by : Name of person with date
Reviewed by : Name of person with date
Approved by : Name of person with date

| S No. | Nature of procedure | Extent of check | Basis of sample | Done by |
|---|---|---|---|---|
| a) | Vouch few purchase invoices of paper from purchase records of concern. | | | |
| b) | Trace these invoices into account books of concern. | | | |
| c) | Verify few purchase invoices of paper on GST portal. | | | |
| d) | Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material. | | | |

**Question 20**

W, the auditor of SKM Ltd. asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insists him to draw detailed audit procedures. On the request of auditor W completes audit strategy as well as audit procedures as prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment. [SM]

**Solution**

The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, as discussed earlier, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.

Accordingly, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures.

*"Discipline always wins over Motivation"*

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## Test Your Understanding

**Question 1**

During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

**Solution**

Auditor shall document discussions of significant matters with management, those charged with governance, and others, including nature of significant matters discussed and when and with whom discussions took place.

In instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed.

Although issue was resolved, it is necessary to document the same by including detail of person with whom discussions took place along with date.

**Question 2**

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2024 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file. Standard on Quality Control (SQC) 1 provides that audit documentation is the property of the auditor. He may make portions of, or extracts from, audit documentation available to clients subject to some conditions.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

(↑ RTP Jan'25)

**Solution**

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit





work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

### Case Study

CA Rajan Pillai is heading the engagement team conducting audit of a company.

While audit is in progress, consider following issues regarding audit documentation:-

A. Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).

B. The team has determined materiality for financial statements as a whole.

C. The team has assessed risks of material misstatements to be low.

D. CA Shobhit is responsible for attending inventory count process and putting down its documentation part.

E. During the course of audit, many related party transactions have come to notice.

On the basis of above, answer the following questions:

**(1) Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?**

a) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.

b) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.

c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.

d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.

**(2) As regards materiality, which of the following statements is most appropriate in context of audit documentation?**

a) Materiality has already been determined. There is no need to put it into working papers.

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b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.

c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.

d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.

**(3) As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?**

a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.

b) Details of risk assessment procedures have to be documented.

c) Details about how understanding of each component of internal control was obtained has to be documented.

d) Precise calculation of risk of material misstatements has to be documented.

**(4) CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?**

a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.

b) Detail of test counting undertaken should form part of audit documentation.

c) Detail of obsolete goods found should form part of audit documentation.

d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

**(5) As regards related party transactions, which of the following should not be part of audit documentation?**

a) Management representation letter in this regard

b) Related party transaction policy of the company

c) Documentation to show that such transactions are at arm's length basis

d) Documentation to show that such transactions are at close length basis.

**Answers** 1. c 2. c 3. d 4. d 5. d





**(1) Which of the following statement is appropriately suited to preparation of audit documentation?**

a) Audit documentation has to be prepared simultaneously as audit progresses.

b) Audit documentation has to be prepared 60 days after date of audit report.

c) Audit documentation has to be prepared when information is required by regulator.

d) Audit documentation has to be prepared 60 days after completion of audit work.

**(2) Audit documentation is owned by: -**

a) Client

b) Auditor

c) Team member responsible for documentation

d) Regulator

**(3) Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?**

a) Previous years audited financial statements

b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption

c) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers

d) Statement showing verification of ageing of trade receivables as on date of balance sheet

**(4) Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?**

a) Evaluation of objectivity and competence of internal auditor has to be documented.

b) Nature of work used and reason for relying upon work used forms part of documentation.

c) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.

d) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.

**Ans:** 1) a 2) b 3) c 4) d

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**Correct/Incorrect**

1. As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor. [SM]

Incorrect: As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

2. Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.

Incorrect: SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

**Past Exams/RTPs/MTPs/SM Questions**

**Question 1**

Define audit documentation. Also give some examples. [SM]

**Solution**

Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Audit Documentation include: Audit programmes, Analyses, Issues memoranda, Summaries of significant matters, Letters of confirmation and representation, Checklists, Correspondence (including e-mail) concerning significant matters

**Question 2**

M/s. PK & Company, Chartered Accountants, are the statutory auditors of JC Limited. CA Tarun, partner f M/s. PK & Company, was entrusted to supervise and verify the inventory items as on 31.03.2024. uring the process of verification, a large chunk of draft inventory sheets were accumulated and then final inventory sheet was prepared. The audit assistant has kept all these drafts and the final inventory eet in the audit file. Is the approach of the audit assistant correct? Which papers/ documents may t be included in the audit documentation? [Sep'24]





**Solution**

In the given case, the audit assistant has kept a large chunk of draft inventory sheets and the final inventory sheet in the audit file which is not correct as the auditor is not required to document draft inventory sheets. Auditor should ensure that only final inventory sheets will form part of the audit documentation. Thus, approach of the audit assistant of filing draft and final inventory sheet is not correct.

As per SA 230, "Audit documentation", audit documentation may be recorded on paper or on electronic or other media.

The auditor need not include in audit documentation:

- superseded drafts of working papers and financial statements,
- notes that reflect incomplete or preliminary thinking,
- previous copies of documents corrected for typographical or other errors, and
- duplicates of documents.

**Question 3**

What do you mean by Audit Documentation? Also explain the nature and purpose of audit documentation. [ICAI SM + RTP May-19 + MTP Nov-21 + Nov-22]

**Solution**

Definition as discussed above.

Nature of Audit Documentation

Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

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**Question 4**

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand significant matters arising during the audit. Explain the above statement and also give examples of significant matters. [RTP Nov-22/20]

OR

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Explain stating clearly the examples of significant matters. [RTP Sep'24]

**Solution**

As per SA 230, "Audit documentation" judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating
  a. that the financial statements could be materially misstated, or
  b. a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

- ✓ An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results.
- ✓ Documentation of the professional judgements made, where significant, explains the auditor's conclusions and reinforces the quality of the judgement.
- ✓ Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

**Question 5**

Give some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment where the matters and judgments are significant. [MTP Oct-20]



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**Solution**

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ✓ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ✓ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ✓ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

**Question 6**

One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of the entity. State six other factors in this respect. [ICAI SM + MTP May'24/Apr'19]

**Solution**

The form, content and extent of working papers depend on factors such as:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

**Question 7**

TRS & Associates, Chartered Accountants, having completed the audit of Genuine Leathers Ltd has started the assembling of final audit file. TRS & Associates has established policies and procedures for the timely completion of the assembly of audit files. Explain the various aspects related to final audit file discussed in SA 230 giving specific reference to SQC-1, wherever required. [RTP May-22]

OR

M/s KSJS & Associates are the statutory auditors of Moon Ltd. for the financial year 2023-24. During an audit briefing, CA Sanket, the engagement partner, explained that the auditor must assemble the audit documentation in an audit file and complete the administrative process of finalising the audit file on a timely basis after the date of the auditor's report. He also highlighted the requirements of SQC 1 regarding establishment of policies and procedures for the retention of engagement documentation in a

firm. Explain the requirements related to the timely assembly and retention of audit files in accordance with relevant Engagement and Quality Control Standards. (MTP I Jan'25)

**Solution**

Auditor TRS & Associates, CAs shall assemble audit documentation in an audit file and complete administrative process of assembling final audit file on a timely basis after the date of the auditor's report.

(i) SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

(ii) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

(iii) Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

i) Deleting or discarding superseded documentation.
ii) Sorting, collating and cross-referencing working papers.
iii) Signing off on completion checklists relating to the file assembly process.
iv) Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

Retention Period

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

**Question 8**

Rajni, a CA student, has understood that SA 230 requires auditor to prepare audit documentation on a timely basis. While reading about SQC 1, she notices that time limit for completion of final audit file is ordinarily not more than 60 days after the date of auditor's report. She finds it to be puzzling. Unable to comprehend, she seeks your guidance. Guide her. [RTP May'24]





**Solution**

SA 230 requires that the auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

SQC 1, however, requires auditor to complete assembly of final audit file in ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is only an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Therefore, auditor shall prepare documentation on a timely basis. However, for completion of assembly of final audit file which is an administrative process, time period of 60 days after the date of auditor's report has been required in SQC 1.

**Question 9**

CA B, an auditor, after the completion of busy audit season, was occupied in assembling of final audit files of one of his client. First of all, he started preparing various documents of that client and then kept those documents in various folders. He was preparing documents as well as audit file in paper form because he believed that it is mandatory. He could complete documentation as well as assembling of final audit file of that client after three months from the date of audit report. Generally, he retains audit file of the clients for 4 years from the date of audit report. Check the validity of the action of CA B. [May'24]

**Solution**

Paper form mandatory?

Audit documentation may be recorded on paper or on electronic or other media. Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. Hence the views of CA B that audit documentation should be maintained mandatorily in paper form is not correct.

Preparation of Audit Documentation

The auditor shall prepare audit documentation on timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. Completing the audit documentation by CA B not on timely basis is not proper.

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**Assembly of Audit File**

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. In the given situation, CA. B, after completion of audit season, is completing the audit file as well as assembling of final audit files of his client after three months of the date of audit report which is not valid as per SQC 1.

**Retention of Audit Documentation**

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and Related Services", requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report. He retains audit file of the client for 4 years from the date of audit report is also non-compliance of SQC 1.

**Question 10**

CA N, statutory auditor of Rock Limited, is in the process of final assembly of audit file. Under what circumstances, a statutory auditor can make changes to audit documentation during final assembly process of audit file? Give a few examples of such changes. [MTP Sep'24]

**Solution**

Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

i) Deleting or discarding superseded documentation.
ii) Sorting, collating and cross-referencing working papers.
iii) Signing off on completion checklists relating to the file assembly process.
iv) Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

**Question 11**

"Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain. [ICAI SM]

OR

Discussing meaning of completion memorandum, elaborate upon its importance. [RTP May'24]

**Solution**

Completion memorandum is a summary that describes the significant matters identified during the audit and how they were addressed.





**Importance:**

- ✓ Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.
- ✓ Further, the preparation of such a summary may assist auditor's consideration of the significant matters.
- ✓ It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

**Question 12**

While documenting the nature, timing and extent of audit procedures performed in case of audit of PQR Ltd, explain the important matters its auditor should record. [RTP May-21]

**Solution**

In documenting the nature, timing and extent of audit procedures performed, the auditor of PQR Ltd shall record:

i) The identifying characteristics of the specific items or matters tested.
ii) Who performed the audit work and the date such work was completed; and
iii) Who reviewed the audit work performed and the date and extent of such review.

**Question 13**

While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation. [SM]

**Solution**

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

**Question 14**

A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company. [SM]

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**Solution**

Audit Documentation of a company is not the property of the company rather Audit Documentation is the property of Auditor of that company.

**Question 15**

The working papers of the branch auditor are also the property of the Principal Auditor and the Management of the Company, so they have right to access them. State the relevant SA and comment. [MTP Mar-21]

**Solution**

Ownership of Working Papers: As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers. An auditor is not required to provide the management/ clients or other auditors' access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

From above, it is clear that working papers of the branch auditor are his property only and neither the Principal auditor not management has right to access that. Therefore, statement given in the question is incorrect.



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**Question 1**

Wear & Tear Private Limited is a "start-up" engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

**Solution**

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is "inherent risk."

**Question 2**

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

**Solution**

The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement is "control risk".

**Question 3**

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

**Solution**

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

**Question 4**

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

**Solution**

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

**Question 5**

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

**Solution**

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

**Question 6**

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

**Solution**

She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities". When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.

**Question 7**

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

**Solution**

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.





**Question 8**

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis. Discuss the types of inherent, control and detection risks as perceived by the auditor.

**Solution**

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

**Question 9**

A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2020-21. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question.

**Solution**

The risk mentioned in the question is known as Audit Risk, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

**Question 10**

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

**Solution**

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of

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gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly.

**Question 11**

While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

**Solution**

The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

**Question 12**

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

**Solution**

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

**Question 13**

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

**Solution**

The auditor shall obtain an understanding of internal control relevant to the audit.

Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

**Question 14**

The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.





**Solution**

The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

**Question 15**

Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

**Solution**

The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

**Question 16**

Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

**Solution**

The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

**Question 17**

In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

**Solution**

The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

**Question 18**

Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating

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in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above.

**Solution**

The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

**Correct/Incorrect**

(i) Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(ii) Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Incorrect: The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

(iii) Mr. W, one of the team members of auditor of Different Limited was of the view that understanding the Internal Control of Different Limited will not help in developing an Audit Programme.

Incorrect: Understanding the Internal Control of Different Limited will help in developing an Audit Programme because it will assist the auditor and his team to understand as to how much they can rely on internal control of the company and what audit procedures would be appropriate to be used during the course of audit

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**Question 1**

CA D has been appointed as an auditor of LMP Ltd. Before developing an overall audit plan, CA D wants to get an understanding and knowledge of the Client's business including applicable financial reporting framework. Guide CA D in understanding of the same with reference to the relevant Standard on Auditing. [May'23]

**Solution**

Understanding and Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible.

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the following:

1. Relevant industry, regulatory and other external factors including the applicable financial reporting framework.
2. The nature of the entity, including:
   i) its operations;
   ii) its ownership and governance structures;
   iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   iv) the way the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
3. The entity's selection and application of accounting policies including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
4. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.
5. The measurement and review of the entity's financial performance.

**Question 2**

The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk? [MTP Aug-18 + May-23]

**Solution**

Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

What is not included in Audit Risk ?

i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

**Question 3**

The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels. [RTP Nov-20]

**Solution**

The risks of matericl misstatement may exist at two levels:

i) The overall financial statement level- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

ii) The assertion level for classes of transactions, account balances, and disclosures-Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

**Question 4**

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples. [RTP May-20] OR

Obtaining an understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit. Explain by giving examples. (RTP Nov-23)

**Solution**

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.



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The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

**Question 5**

"The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement"" Explain (SM)

**Solution**

Combined Assessment of the Risk of Material Misstatement

- Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement".
- However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms.
- In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

**Question 6**

Satranga Foods Private Limited is engaged in manufacturing of pickles. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Identify and explain that particular risk in detail. [RTP May'24]

**Solution**

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. Such a risk is referred to as "detection risk".

SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.

Detection risk comprises sampling and non-sampling risk.

a. **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
b. **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

**Question 7**

CA Tina, while inspecting financial statements of a company, notices that gross profit ratio of company has increased from 14% in year 2022-23 to 24% in year 2023-24. Considering the above, she has assessed the risk of material misstatement to be high with respect to assertions relating to revenue and various direct expenses. CA Tina wants to know few possible reasons which could have led to abnormal jump in gross profit ratio. During the discussion among engagement team members, her junior Ms. Tisha, expressed her view that detection risk in this engagement should be kept at high level.

(i) List out a few possible reasons which could have led to abnormal jump in gross profit ratio.

(ii) Do you agree with viewpoint of Tisha? Provide reasons for your answer. (MTP Sep'24)

**Solution**

(i) In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2022-23 to 24% in year 2023-24.

Few possible reasons which could have led to abnormal jump in gross profit ratio include: -

- Overvaluation of inventories
- Overstatement of revenues
- Understatement of direct expenses

(ii) SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.





Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses.

Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected. Therefore, view of Ms. Tisha is not proper.

**Question 8**

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points. (RTP Nov-20)

OR

The objective of an auditor in accordance with SA 315 is to identify and assess risks of material misstatement at financial statement level and assertion level. Which specific activities an auditor is required to perform for the purpose of identifying and assessing risks of material misstatement?

(MTP May'24)

**Solution**

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

**Question 9**

Significant risks often relate to significant non- routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

In context of significant risk, explain the factors to be considered by the auditor in exercising judgment as to which risks are significant risks. [RTP Nov-21 + May-23]

**Solution**

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

a. Whether the risk is a risk of fraud;
b. Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
c. The complexity of transactions;
d. Whether the risk involves significant transactions with related parties;
e. The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
f. Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**Question 10**

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail. [MTP Nov-23]

OR

Auditor or Sunshine Ltd. Is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions. [Dec-21 + RTP Nov-21]

OR

What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions. [ICAI SM]

**Solution**

Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

Risks of Material Misstatement- Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

a. Greater management intervention to specify the accounting treatment.





b. Greater manual intervention for data collection and processing.
c. Complex calculations or accounting principles.
d. The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement- Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Keeping in view above, view of Auditor of Sunshine Ltd is correct.

**Question 11**

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control. [RTP May-20]

**Solution**

Objectives of Internal Control are :

i) transactions are executed in accordance with managements general or specific authorization;
ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
iii) assets are safeguarded from unauthorised access, use or disposition; and
iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

**Question 12**

Briefly discuss the limitations of Internal Control. [MTP Apr-19]

**Solution**

Limitations of Internal Control:

i) Internal control can provide only reasonable assurance: Internal control, no matter how effecti can provide an entity with only reasonable assurance about achieving the entity's financial report

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objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

ii) Human judgment in decision-making: Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

iii) Lack of understanding the purpose: Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

iv) Collusion among People: Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

v) Judgements by Management: Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

vi) Limitations in case of Small Entities: Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

**Question 13**

The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control. [MTP Oct-21/Mar-23]

**Solution**

Division of Internal Control into Components: The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:





i) The control environment;
ii) The entity's risk assessment process;
iii) Monitoring of controls.
iv) Control activities; and
v) The information system, including the related business processes, relevant to financial reporting, and communication;

**Question 14**

"A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud." Explain. [RTP May-18]

**Solution**

Satisfactory Control Environment – not an absolute deterrent to fraud:

Existence of a satisfactory control environment can be a positive factor when auditor assesses risks of material misstatement. However, although it may help reduce risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.

Conversely, deficiencies in control environment may undermine effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, control environment also influences the nature, timing, and extent of the auditor's further procedures.

Control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

**Question 15**

The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

i) Management has created and maintained a culture of honesty and ethical behavior; and
ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment.

[RTP Jan'25 + Nov-22 + RTP Nov-19]

**Solution**

Control Environment – Component of Internal Control: The auditor shall obtain an understanding of the control environment.

As part of obtaining this understanding, the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

i) the governance and management functions and

ii) the attitudes, awareness, and actions of those charged with governance and management.

iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) Communication and enforcement of integrity and ethical values - These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) Commitment to competence - Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

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(c) Participation by those charged with governance - Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) Management's philosophy and operating style - Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) Organisational structure - The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) Assignment of authority and responsibility - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.





(g) Human resource policies and practices - Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

**Question 16**

While conducting the audit of Zeena Limited, CA E is trying to obtain understanding of different components of internal controls of the company. Such an understanding is necessary and is required to be documented in accordance with Standards on Auditing. In this context, how he shall obtain understanding of the risk assessment process of the company and how is this understanding important for the auditor?

**Solution**

CA E, the auditor of Zeena Limited, shall obtain an understanding of whether the entity has a process for: -

a) Identifying business risks relevant to financial reporting objectives
b) Estimating the significance of the risks
c) Assessing the likelihood of their occurrence
d) Deciding about actions to address those risks

Importance to Auditor

- The entity's risk assessment process forms the basis for the risks to be managed.
- If that process is appropriate, it would assist the auditor in identifying risks of material misstatement.
- Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc.
- Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

**Question 17**

Define Monitoring of Controls and in respect of monitoring of controls, answer the following questions:

i) How monitoring of controls would be helpful in assessing the effectiveness of controls?

ii) How can management accomplish monitoring of controls?

iii) What is included in the Management's monitoring activities? [RTP Nov-22]

**Solution**

Monitoring of controls Defined: Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

i. Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

ii. Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a

combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

iii. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement

**Question 18**

CA Amit is the auditor of LMN Ltd. While conducting the audit, he wanted to analyze the different components of internal control of the company.

Identify and explain which component of internal control he is trying to understand in the following two cases: -

i) Whether controls in LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions.

ii) Whether there exists proper segregation of duties in the company and the person responsible for recording a transaction is different from the person authorizing it. [Sep'24]

**Solution**

(i) In this case, CA. Amit is trying to understand that whether controls in the LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions: He is gaining the understanding of the Monitoring of controls component of internal control.

- Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- It helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

(ii) In the given situation, CA Amit is trying to understand that whether there exists a proper system of segregation of duties in the company and the person responsible for recording a transaction is different from the person authorising it. He is gaining an understanding of internal control of the company. In particular, he is understanding "control activities".

- When a person recording a transaction is different from one authorizing it, he gains confidence that there exists a system for preventing misstatements.
- It helps him in gaining insight into the internal control system of the company.

**Question 19**

KR & Associates, an auditor of FDP Ltd., observed that the company has implemented various internal controls addressing financial reporting, operational efficiency, and compliances during their preliminary evaluation. CA Karan suggests that all controls should be assessed to mitigate the risk of material





misstatement in the financial statements, while CA Rajat is of the view that only those controls deemed relevant to the audit should be assessed based on professional judgment.

Comment, whether the auditor should assess all the internal controls or limit the assessment to only those considered relevant by the auditor during the audit. Also, discuss the factors influencing the auditor's judgment on the relevance of controls. (MTP Jan'25)

**OR**

Explain the matters which should be included for factors relevant to the auditors' judgement about whether a control is relevant to the audit. [RTP Nov-22 + MTP May-22]

**Solution**

There is a direct relationship between an entity's objectives and the control it implements to provide reasonable assurance about their achievement. FDP Ltd. has implemented internal controls addressing financial reporting, operational efficiency, and compliance. However, not all of these objectives and controls are relevant to the auditor's risk assessment.

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Facts of Case

In the given case, CA Karan suggests that all controls should be assessed to mitigate the risk of material misstatement in the financial statements, while CA Rajat is of the view that only those controls deemed relevant to the audit should be assessed based on professional judgment.

Conclusion

Based on the factors mentioned above, it can be concluded that the auditors should assess only those controls deemed relevant to mitigate the risk of material misstatement in FDP Ltd.'s financial statements.

**Question 20**

Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control. [RTP May-21]

**Solution**

The auditor shall obtain an understanding of internal control relevant to the audit.

Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures.

**Question 21**

The review of internal controls will enable the auditor to know the areas where control is weak. Explain stating clearly the benefits of evaluation of internal control to the auditor. [RTP Nov-22]

**Solution**

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Benefits of Evaluation of Internal Control to the Auditor

- The review of internal controls will enable the auditor to know:
- whether errors and frauds are likely to be located in the ordinary course of operations of the business;
- whether an adequate internal control system is in use and operating as planned by the management;
- whether an effective internal auditing department is operating;
- whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- whether the controls adequately safeguard the assets;

how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

how reliable the reports, records and the certificates to the management can be;

the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

what would be appropriate audit technique and the audit procedure in the given circumstances;

what are the areas where control is weak and where it is excessive; and

whether some worthwhile suggestions can be given to improve the control system.





**Question 22**

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard. [MTP May-22]

**Solution**

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as under:

a. The classes of transactions in the entity's operations that are significant to the financial statements;
b. The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
c. The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
d. How the information system captures events and conditions that are significant to the financial statements;
e. The financial reporting process used to prepare the entity's financial statements;
f. Controls surrounding journal entries.

**Question 23**

ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established and maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company. [Nov-22]

**Solution**

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as

"the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures.

**Question 24**

Internal Control Questionnaire is a comprehensive series of questions concerning internal control. A company is engaged in business of manufacturing of chemicals. It has two plant locations in city "A" and one plant location in city "B" involving huge value of assets. Building at three locations is owned by the company. The company earns handsome profits and does not want to suffer losses due to business interruptions. It has a dedicated department for looking after insurance matters. As an auditor, prepare an internal control questionnaire concerning this department for obtaining staff responses.

[MTP II May'24]

**Solution**

Internal Control Questionnaire

- Are competitive quotes obtained from different insurers?
- Is comprehensive insurance cover obtained for fire, flood, burglary, earthquake risks etc.?
- Are all three locations in city A and B covered?
- Are all assets consisting of building, plant & machinery and inventories covered?
- Is there an adequate procedure to ensure that assets acquired between two renewal dates are also covered by insurance?
- Is there an official who decides on value for which policies are taken?
- Does officer who decides on policy value review periodically adequacy of insurance cover?
- Is loss-of-profits insurance cover taken?
- Have there been any instances of rejection of claims?
- Are pending claims followed-up with insurers?

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**Question 1**

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

**Solution**

Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a "control deficiency".

**Question 2**

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

**Solution**

It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

**CASE STUDY-1**

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment: -

(i) The revenue of company has fallen from ₹ 50 crore in last year to ₹ 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.

(ii) Due to advent of new products in the market, company's products are fast becoming outdated.

(iii) A large customer having an outstanding balance of ₹ 5 crore has failed to pay to the company despite efforts made by the company.

(iv) Inventory holding period has increased from 30 days in last year to 90 days.

(v) The company also gets carried out job operations from third parties.

Therefore, parts of inventories are lying with third parties.

Based on above, answer the following questions: -

1. Regarding drastic fall in revenue of the company, which of the following is an audit risk?
(a) Fall in revenue would result in fall of profits for the company.
(b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.
(c) The company can explore some new line of activity, if demand of its products is falling.
(d) Fall in revenue would mean lower tax liabilities for the company.

2. The company's products are getting outdated in the market. Which of the following is an audit risk?
(a) The company should devise strategies to sell products in the market.
(b) Inventories may be understated in such a scenario.
(c) Inventories may be overstated in such a scenario.
(d) The company should launch a 1+1 free offer for its customers.

3. A large customer has failed to pay to the company. Identify audit risk from below:
(a) Receivables may be misstated if irrecoverable debt is not written off.
(b) Receivables may be overstated if irrecoverable debt is not written off.
(c) Writing off irrecoverable debt would impact profits of company adversely.
(d) Failure to recover outstanding debt would impact cash flows of company adversely.

4. Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.
(a) There is a risk of overstatement of inventories.
(b) There is a risk relating to existence of inventories.
(c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.
(d) There is a risk relating to holding and storage cost of inventories.

5. Part of inventories are lying with third parties. Identify audit risk involved.
(a) There is a risk that third parties do not manufacture according to specifications of the company.
(b) There is a risk that by getting job work done from third parties, company is increasing its costs.
(c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.
(d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.





**Solution** 1. (b) 2. (c) 3. (b) 4. (a) 5. (c)

## CASE STUDY-2

CA Piyush is understanding internal controls as part of audit exercise of a company.

It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management.

Till now, he has studied controls over inventories and bank. Few of such controls are listed below: -

| Nature of Control | Control description |
|---|---|
| Control over inventories | Inventories of the company lying at each location should be insured. |
| Control over inventories | There should be inventory counts on a regular basis for each location of the company. |
| Control over Bank operations | Bank reconciliations are to be performed at regular intervals. |

Based on above, answer the following questions: -

1. Which of the following most appropriately describes test of control regarding insurance of inventories?
a. Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.
b. Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.
c. Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.
d. Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.

2. Which of the following most appropriately describes test of control regarding inventory counts?
a. Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.
b. Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.
c. Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.
d. Attend inventory count and perform test count.

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3. While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard: -

a. Bank reconciliations are not being performed regularly as concerned staff is overburdened.
b. Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.
c. Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.
d. Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.

4. Since the company is a new client, which of the following statements is most appropriate?

a. There is reduced detection risk.
b. There is increased detection risk.
c. There is no effect on detection risk.
d. Detection risk should be increased to lower audit risk.

5. Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?

a. More substantive procedures would require to be performed.
b. Less substantive procedures would require to be performed.
c. There is no effect on substantive procedures.
d. There is no effect on substantive procedures as audit risk is low.

1. (b) 2. (c) 3. (c) 4. (b) 5. (a)

## Correct/Incorrect

(i) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

Correct: Tests of Control are performed to obtain audit evidence about the effectiveness of:

a. the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and
b. the operation of the internal controls throughout the period.

(ii) Information obtained by performing risk assessment procedures shall not be used by the auditor as audit evidence to support assessments of the risks of material misstatement.





Incorrect: Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement.

## Past Exams/RTPs/MTPs/SM Questions

### Question 1

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points. (RTP Nov-20)

OR

The objective of an auditor in accordance with SA 315 is to identify and assess risks of material misstatement at financial statement level and assertion level. Which specific activities an auditor is required to perform for the purpose of identifying and assessing risks of material misstatement?

(MTP May'24)

**Solution**

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

### Question 2

Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls. (RTP May'18)

**Solution**

Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

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**Question 3**

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples. [RTP Nov-20]

**OR**

CA Q is the engagement partner for the audit of a Departmental store. As a part of the risk assessment procedure, he wants to make inquiries of the management and others within the entity. What kind of information can the auditor get by inquiring from the following? (i) Internal audit personnel (ii) In-house legal counsel (iii) Marketing or sales personnel (iv) Information systems personnel [May'24]

**Solution**

Inquiries of Management and Others Within the Entity: Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Examples

- ✓ Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- ✓ Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- ✓ Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- ✓ Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post- sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract.
- ✓ Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- ✓ Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- ✓ Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.





**Question 4**

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail. [RTP Nov-20/23]

**OR**

Discuss how "analytical procedures" performed as "risk assessment procedures" can be useful to an auditor. (ICAI SM)

**Solution**

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist.

Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

**Question 5**

CA Srishti, while auditing KSM Private Limited for the first time, utilised software to analyse financial data, comparing amounts recorded in the financial statements for the current audit year with the preceding two years. Her objective was to evaluate the risk of material misstatement. Identify the type of audit procedure performed by CA Srishti in the given case, discuss its relevance, and explain whether an auditor's opinion can solely rely on such procedures. (Jan'25)

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**Solution**

In the given case, CA Srishti is performing analytical procedures as risk assessment procedures.

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Analytical procedures performed as risk assessment procedures may include both financial and non-financial information.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. Thus, it can be concluded that auditor's opinion cannot be solely based upon such procedures.

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**Question 6**

CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations. [July-21]

**Solution**

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Examples of audit procedures which include observation or inspection of the entity's operations are:

a. Documents (such as business plans and strategies), records, and internal control manuals.
b. Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)
c. The entity's premises and plant facilities.

**Question 7**

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. [RTP Nov-20] OR





SA 330 states that auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to operating effectiveness of relevant controls. Briefly discuss when such tests are to be designed and performed in accordance with SA 330?

If an auditor intends to place greater reliance on effectiveness of a control, state its likely effect on audit evidence to be obtained as a result of such tests of controls. Why a higher level of assurance may be sought by an auditor about the operating effectiveness of controls? [MTP 1 Jan'25]

**Solution**

Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

a. The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
b. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence, the greater the reliance the auditor places on the effectiveness of a control.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

**Question 8**

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls.

[RTP Nov-20]

**Solution**

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.

Matters the auditor may consider in determining the extent of test of controls include the following:

1. The frequency of the performance of the control by the entity during the period.

2. The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
3. The expected rate of deviation from a control.
4. The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
5. The extent to which audit evidence is obtained from tests of other controls related to the assertion.

**Question 9**

Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting a control. [MTP Apr-23 + Nov-19]

**Solution**

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

i) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
ii) The risks arising from the characteristics of the control, including whether it is manual or automated
iii) The effectiveness of general IT-controls;
iv) The effectiveness of the control and its application by the entity, including the nature and
v) extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control
vi) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
vii) The risks of material misstatement and the extent of reliance on the control.

**Question 10**

CA B, was the auditor of Star Limited. He wanted to ensure that the company had correctly reconciled its bank accounts and also wanted to understand whether and how far the internal control system was operating in the company. What kind of test of control was CA B performing? What are the other procedures that can be applied while undertaking test of controls? [Sep'24]

**Solution**

Inquiries of Management and Others Within the Entity: After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation.

Test of controls are performed to obtain audit evidence about the effectiveness of the: -

i) Design of the accounting and internal control system
ii) Operation of the internal control throughout the period





In the given case, CA B was performing Re-performance.

It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

Other procedures that can be applied while undertaking test of controls are:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

**Question 1**

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act,2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

**Solution**

If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

**Question 2**

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor.

**Solution**

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

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**MCQs**

**Which of the following is true regarding materiality?**

(a) It is unaffected by nature of an item.
(b) It is unaffected by requirements of law or regulations.
(c) It is not a matter of professional judgment.
(d) It is not always a matter of relative size.

**Ans. (d)**

**Correct/Incorrect**

1. There is direct relationship between materiality and the degree of audit risk. (ICAI SM)

Incorrect: There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.





**Question 1**

You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark? [RTP May-22 + May-23]

**Solution**

SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements. Example - assets, liabilities, equity, revenue, expenses;
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. Example - for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed [Example- if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings);
- The relative volatility of the benchmark.

**Question 2**

Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. [MTP Oct-19]

**Solution**

Revision in Materiality level as the Audit Progresses: Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Example: If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

**Question 3**

CA Y, statutory auditor of a company, is in process of determining materiality for financial statements while planning audit. Since materiality is a matter of professional judgment and is affected by auditor's perception of financial information needs of users of financial statements, he is reasonably making certain assumptions about users of financial statements. Which reasonable matters are likely to be assumed by him in respect of users? [MTP Sep'24 + RTP May-21 + Nov-23]

**Solution**

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for CA Y to assume that users:

a. Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
b. Understand that financial statements are prepared, presented and audited to levels of materiality;
c. Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
d. Make reasonable economic decisions on the basis of the information in the financial statements.

**Question 4**

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain. [RTP May-21]

**Solution**

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements.

Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:





1. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
2. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
3. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

**Question 5**

Whether misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements? Explain with examples [SM]

**Solution**

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1. Whether **law, regulations or the applicable financial reporting framework** affect users' expectations regarding the measurement or disclosure of certain items.

Example
Related party transactions, and the remuneration of management and those charged with governance.

2. The **key disclosures** in relation to the industry in which the entity operates.

Example
Research and development costs for a pharmaceutical company.

3. Whether attention is focused on a **particular aspect of the entity's business that is separately disclosed** in the financial statements.

**Example**
A newly acquired business.

**Question 6**

Is materiality required to be documented by the auditor? What factors have to be considered this regard? [SM]

Audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures

(c) Performance materiality and

(d) Any revision of (a)-(c) as the audit progressed.

**Question 7**

While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk. [RTP May-22]

**Solution**

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Materiality and audit risk are considered throughout the audit, in particular, when:

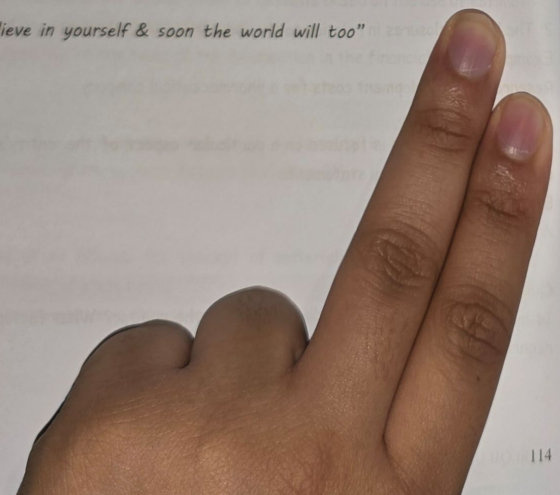
(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

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**Question**

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

**Solution**

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach nonstatistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

**MCQs**

**Which of the following is not an advantage of statistical sampling?**

(a) Sample size does not increase in proportion to size of area tested.

(b) Sample selection is more objective.

(c) It provides a means of deriving a calculated risk and corresponding precision.

**(d) In case of verifying compliance with specific legal requirements, it is suitable.**

**Correct/Incorrect**

1. The method which involves dividing the population into groups of items is knows as block sampling.

Incorrect: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

2. Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Incorrect: Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

3. Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Incorrect: Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

4. Sample need not be representative

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must representative. This means that it must be closely similar to the whole population although necessarily exactly the same. The sample must be large enough to provide statistically meaning results.

5. The objective of stratification is to increase the variability of items within each stratum therefore allow sample size to be reduced without increasing sampling risk.

Incorrect: The objective of stratification is to reduce the variability of items within each stratum therefore allow sample size to be reduced without increasing sampling risk.

6. When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

7. Stratified Sampling is used for homogeneous population.

Incorrect: Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

8. Non statistical sampling is considered to be more scientific than the statistical sampling.

Incorrect: Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non-statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

9. In case of Statistical sampling, auditor's bias in choosing sample is involved.

Incorrect: Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance



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of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without and scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

10. In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population. [Jan-21]

Incorrect: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

11. Low acceptable sampling risk requires larger sample size.

Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

The approach to audit and extent of checking are undergoing a progressive change in favour of more attention towards the questions of principle and controls with a curtailment of non-consequential routine checking. Discuss the given statement. [May-22 + MTP May-22]

**Solution**

Sampling: An Audit Procedure:

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and cost involved.

With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors.

Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a

curtailment of non-consequential routine checking. By routine checking, we traditionally th... extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. Th... nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done a... what extent it has to be done. It is also not obligatory that the auditor must adopt the sa... technique. What he is to do as an auditor is to express his opinion on the financial statements and be... bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that ... lead him to an informed professional opinion. On consideration of this fact, it can be said that it is ... the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e. sampling), he should adopt standards and techniques which are widely followed and which have ... recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

**Question 2**

Explain the meaning of Audit Sampling as per the relevant standard on auditing. State the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

[RTP Nov-22 +MTP Oct-21]

**Solution**

As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is - the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

- ✓ Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.
- ✓ Sample Size - The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- ✓ Selection of Items for Testing - The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.



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**Question 3**

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail. [RTP May-21]

**Solution**

In most of circumstances, evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records.

Sampling is used as a part of Test of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e checking of transactions and balances)

- ✓ If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.
- ✓ On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

**Question 4**

Audit testing done through Statistical sampling is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the

appropriate sample size in varying circumstances. Explain and also state advantages of Statistical sampling? [RTP May-22]

Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

Advantages of Statistical Sampling in Auditing:

The advantages of statistical sampling may be summarized as follows:

i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
ii) The sample selection is more objective and thereby more defensible.
iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

**Question 5**

You are the statutory auditor of NP Ltd. Looking at the huge size of similar transactions, you directed your team members to use statistical sampling. One of the team members, Mr. Q, wants to select samples based upon his personal experience & knowledge as he is not aware of statistical sampling. You are required to explain to Mr. Q why the use of statistical sampling method is more scientific and appropriate. [Sep'24] OR

ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example. [MTP Apr-22]

**Solution**

Statistical sampling: Statistical sampling is an approach to sampling that has the random selection of the sample units and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.



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In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.

Features/Characteristics of Statistical Sampling:

(1) Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

(2) Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(3) There Is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

**Question 6**

What are the matters that the auditor shall consider while designing an audit sample? (Nov'22)

**Solution**

When designing an audit sample,

- the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.
- Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- In fulfilling the requirement of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

**Question 7**

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. Guide the auditor on the use of stratification and value-weighted sampling techniques. [RTP Nov-21]

**Solution**

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value - weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

Dividing a population into discrete sub population which have identifying characteristics is called as Stratification. Each Sub population is called as Stratum and units under those sub population are referred to as Strata.

The results of samples from the units drawn under each sub population are projected to that respective stratum. In order to draw an opinion on the overall population, the auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.

Projected misstatements of each stratum will be combined together to consider the possible effect of misstatement in the account balances and class of transactions.

Example: 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.





One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

**Question 8**

CA Shubham, the auditor of Sigma Limited, is performing tests of controls and tests of details using audit sampling. During these procedures, he observed deviations in compliance with management's prescribed procedures for sales transactions of small values of a product at one location during tests of controls. Additionally, misstatements were identified in the sample related to these small-value sales transactions during tests of details. How should he proceed to analyse the nature and cause of the deviations and misstatements observed in the sample results? (MTP 1 Jan'25)

**Solution**

In the given case, while performing tests of details on a sample in respect of sales, misstatements have been found by CA Shubham in selected sample pertaining to the sales transactions of small values. This indicates observance of deviations and misstatements while performing tests of controls and tests of details respectively in selected samples.

As per SA 530, "Audit Sampling", in analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.

In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items.

In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud. Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remaining of the population.

**Question 9**

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. Explain [RTP May-20]

**Solution**

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

**Question 10**

With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details –
(i) The desired level of assurance (ii) Stratification of the pollution. [Dec-21]

**Solution**

Examples of factors influencing Sample Size for Test of Details:

(i) Desired Level of Assurance: An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

(ii) Stratification of population: When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.





**Question 11**

Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan. [RTP Nov-20 + Nov-23]

**Solution**

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

i) Size of the organisation under audit.
ii) State of the internal control.
iii) Adequacy and reliability of books and records.
iv) Tolerable error range.
v) Degree of the desired confidence.

**Question 12**

CA X is not sure about the kind of Sampling method to be used for audit of a company. Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing. [MTP Nov-21]

**Solution**

CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

(1) Random selection.
(2) Systematic selection.
(3) Monetary Unit sampling.
(4) Haphazard selection.
(5) Block selection.

Advantages of Statistical Sampling in Auditing: [Already covered in Q4]

**Question 13**

Explain the following terms with reference to Audit Sampling :
(i) Stratification
(ii) Tolerable misstatement
(iii) Tolerable rate of deviation [RTP May-21]

(i) Stratification - The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).



CA Intermediate Notes

(ii) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

(iii) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

**Question 14**

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range. Explain about that method. [RTP Nov-22]

Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.

- ✓ It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
- ✓ Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cellphones like the random number generator.

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This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.

**Question 15**

During the audit of a company, CA Z is using a software to select samples pertaining to sales records of the company. While performing this process, a window opens in software prompting the user to enter certain information. CA Z is in the process of entering information in this regard as given under: -

| | |
|---|---|
| Selection Interval | ? |
| Number of records to select | 100 |
| Starting record number to select | 1 |
| Ending record number to select | 1000 |
| File name | Sales |

Going through the above fields, which method of sampling is likely being used in the software? Discuss. Which foremost consideration should be kept in mind by auditor for selecting samples in such a manner?





Additionally, partner of CA Z suggested him to select the first 200 sales invoices from the sales book of the last month. Which method of sampling is being suggested by partner of CA Z? (MTP Sep'24)

**Solution**

In the given case, method of sampling being used in software is known as interval sampling or systematic sampling.

It is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval.

Sampling interval = Sampling units in population/Sample size i.e 1000/100

Sampling interval = 10
Records selected = 100
Software would pick every 10th record from 1 to 1000 records.

When using this method, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Further, partner of CA Z suggested him to select the first 200 sales invoices from the sales book for the last month. He is suggesting him block sampling for sales, this method involves selection of a block(s) of contiguous items from within the population.

**Question 16**

Auditors cannot normally examine all the information available to them as it would be impracticable to do so and using audit sampling will produce valid conclusions. Samples should be selected in such a manner that it is representative of the population from which the sample is being selected. Which sample selection method is used in the following two cases? Identify and explain them briefly.

i) Auditor divided the trade receivables in three groups: balances above ₹ 20 lakhs, balances between ₹ 10 lakhs to ₹ 20 lakhs and balances below ₹ 10 lakhs. He selected different percentages of items from each group.

ii) Auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year. [Sep'24]

**Solution**

Sample Selections Methods:

(i) Stratified Sampling method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

- Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum.
- The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
- In the given case, Auditor divided the trade receivables in three groups i.e. balances above ₹ 20 lakhs, balances between ₹ 10 lakhs to 20 lakhs and balances below ₹ 10 lakhs and he selected different percentages of items from each group will be considered as Stratified Sampling.

(ii) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population.

- Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.
- In the given case, the auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year is Block Selection Method.

**Question 17**

CA B is appointed as an auditor of M/s. Divine Pharmacy, a wholesale medicine supplier. While auditing for the financial year 2020-21, CA B wants to use test checking technique. Advise CA B, what kind of precautions should be taken by him in this regard. [July-21 + SM]

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**Solution**

The following Precautions should to be taken by CA B while applying test check techniques:

- ✓ Thorough study of accounting system should be done before adopting sampling
- ✓ Proper study of internal control systems.
- ✓ Areas which are not suitable for sampling should be carefully considered. eg: compliance with statutory provisions, transactions of unusual nature etc.
- ✓ Proper planning for Sampling methods to be used and explaining the staff,
- ✓ Transactions and balances have to be properly classified (stratified)
- ✓ Sample size should be appropriately determined.
- ✓ Sample should be chosen in unbiased way,
- ✓ Errors located in the sample should be analyzed properly.

**Question 18**

Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example. [RTP May-20]





**Solution**

Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

**Example:** Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

**Question 19**

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? [SM]

As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Sampling risk can lead to two types of erroneous conclusions:

i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

"Make sure you SAMPLE,
Good Questions for Next Revision"

**Question 1**

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss. Discuss, how you should, proceed and communicate in above situation before signing audit report. (SM)

**Solution**

The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality.

It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

**Question 2**

Mr. D an auditor, while auditing ACE Ltd., identified certain misstatements in relation to particular class of transactions and account balances. He had communicated same to those charged with governance and also taken written representation for the same. State the audit documentation required by the auditor regarding misstatements identified during the audit. (May'24 + SM)

**Solution**

The audit documentation shall include: -

a. The amount below which misstatements would be regarded as clearly trivial;
b. All misstatements accumulated during the audit and whether they have been corrected; and
c. The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

**Question 3**

Up and High Private Limited has started its export business during the year 2023-24. The company was catering to domestic market only in past years. CA H, statutory auditor of the company, is of the view that the company has understated its revenue by ₹ 50.00 lacs in the year 2023-24 by not complying with requirements of AS 9 relating to revenue recognition.

i) Discuss responsibilities of statutory auditor to communicate with management in the above situation in accordance with SA 450. Also explain the usefulness of such communication.





ii) If management refuses to correct misstatement as communicated by the statutory auditor, how should he proceed? [MTP-1 May'24]

**Solution**

The above situation is an example of misstatement relating to noncompliance with requirements of AS 9 identified during audit. In accordance with requirements of SA 450, the auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

**MCQs**

**Which of the following is false regarding communication of misstatements identified during course of an audit?**

a. The auditor should request those charged with governance for correction of identified misstatements.
b. The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.
c. The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.
d. The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Ans. (b)

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## MCQs

**1. The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?**

(a) It results in complex business environment.
(b) It results in simple business environment and easier audit.
(c) Automation has no relationship with complexity of business environment.
(d) It results in simple business environment. However, it increases complexity of audit.

**2. Which of the following is not a risk to a company's internal control due to its IT environment?**

(a) Potential loss of data
(b) Inability to access data when required
(c) Unauthorized access to data
(d) Processing of large volumes of data

**3. Which of the following is not an example of "General IT controls"?**

(a) Controls pertaining to Disaster recovery plan
(b) Controls pertaining to batch preparation
(c) Controls pertaining to data security
(d) Controls pertaining to validation of input data in an application

1. a 2. d 3. d

### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Explain the meaning of automated environment. Also discuss the key features of an automated environment. [RTP May-19]

**Solution**

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems - also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

Some of the key features of an automated environment are as follows:

- ✓ Enable Faster Business Operations
- ✓ Connectivity & Networking Capability
- ✓ Accuracy in Data Processing & Computation
- ✓ Ability to process Large Volumes of Transactions
- ✓ Better Security & Controls



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- ✓ Less prone to Human Errors

**Question 2**

List the points that an auditor should consider to obtain an understanding of the Company's automated environment. [RTP Nov-22 +MTP May-22+Oct-21]

**Solution**

Understanding of the Company's Automated Environment: Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

**Question 3**

Which are specific risks to the company's internal control having IT environment? [RTP Nov'22]

**Solution**

Given below are some such risks that should be considered:

- Inaccurate processing of data, processing inaccurate data, or both.
- Unauthorized access to data.
- Direct data changes (backend changes).
- Excessive access / Privileged access (super users).
- Lack of adequate segregation of duties.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Loss of data.

**Question 4**

Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting. [RTP May'18]

**Solution**

Impact on substantive checking: Inability to address above discussed risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested

thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.

Impact on controls: It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

Impact on reporting: Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

**Question 5**

Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail. [RTP May-21]

**Solution**

"General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:"

i) Data center and network operations
ii) Program change
iii) Access security
iv) Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

Data Center and Network Operations

Objective: To ensure that production systems are processed to meet financial reporting objectives.

Activities:

- Overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups.
- Such controls also help in performance monitoring of operating system, database and networks. Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.





**Question 6**

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the selection of audit samples. Explain giving other relevant points also in the above context of data analytics. [RTP May-21 + May-23]

**OR**

Companies are increasingly using data analytics for managing their operations. Auditors can also obtain good results by using data analytics. What are the tools and techniques used by auditors in applying the principles of Data Analytics and in which areas data analytics can be used by auditors? (SM + RTP Sep'24)

**Solution**

The tools and techniques that auditors use in applying principles of data analytics are known as Computer Assisted Auditing Techniques (CAATs).

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- ✓ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ✓ Selection of audit samples – random sampling, systematic sampling.
- ✓ Re-computation of balances – reconstruction of trial balance from transaction data.
- ✓ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ✓ Analysis of journal entries as required by SA 240.
- ✓ Fraud investigation.
- ✓ Evaluating impact of control deficiencies.

**Question 7**

The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective? [May-22]

**OR**

Foreceful Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2020-21, the company transferred its accounts from manual to computerized system (SAP). PQR & Co., Chartered Accountants have specialization in the system audit and have been appointed as the system auditor. PQR & Co., at the end of the audit concludes that there are certain findings or exceptions in IT environment and IT controls of the company which needs to be assessed and reported. Mention those points of consideration. [July-21 + MTP May-23]

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**Solution**

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- ✓ Are there any weaknesses in IT controls?
- ✓ What is the impact of these weaknesses on overall audit?
- ✓ Report deficiencies to management – Internal Controls Memo or Management Letter.
- ✓ Communicate in writing any significant deficiencies to Those Charged With Governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

**Question 8**

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement. Discuss stating the different ways testing is performed in an automated environment.

[MTP Oct-18]

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**Solution**

The following are different ways testing is performed in an automated environment :

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance.

Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.





When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application

**Question 9**

In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it? [Nov-22]

**Solution**

Access Security

Objective: To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- Security Organization & Management
- Security Policies & Procedures
- Application Security
- Data Security
- Operating System Security
- Network Security
- Physical Security

**Question 10**

Discuss relationship between "General IT controls" and "application controls" in an automated environment. [SM]

**Solution**

General IT Controls vs. Application Controls

- These two categories of control over IT systems are interrelated.
- The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

**Question 11**

Given below is a table containing Column A and Column B. Column A contains description of certain controls in an automated environment. Complete Column B by stating appropriate type of control.

| Column A (Description of control in an automated environment) | Column B (Type of Control?) |
|---|---|
| 1. Reasonableness checks | ? |
| 2. Controls over Data centre and network operations | ? |
| 3. Controls over application system acquisition, development and maintenance | ? |
| 4. Program change controls | ? |

[MTP May'24]

**Solution**

1. Application Controls & 2,3,4 General IT Controls

**Question 12**

You are appointed as the auditor of a company manufacturing paints. The company has a robust system of internal control. Most of the controls in the company are automated and they are working effectively. However, in certain situations, manual elements in internal controls are more suitable. What are the circumstances where manual elements in internal controls may be more suitable? (May'24)

**Solution**

Manual elements in internal control may be more suitable in the following circumstances:

- Where judgment and discretion are required.
- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

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**Question 13**

Z and Associates are the auditors of Realton Ltd., an export oriented unit, which specializes in manufacturing oil extraction plants. Since many complex processes are involved, they are digitizing their operations. They are restructuring their business models which are driven by technology. Since most of the operations of the company are automated, Z and Associates are planning to do Digital Audit. Explain the use of digital technology in the conduct of an audit. [Sep'24]

**Solution**

Use of Digital Technology in the conduct of an audit: Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.





In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.

- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
- By using such tools, auditors can conduct audits in a better way and devote more attention to areas requiring greater focus.
- Digital audit is helping auditors to better identify risks making use of technology.

*Very few students diligently cover Question Banks,*

*Kudos for being among the Top!*

## SA 500 Audit Evidence

### Test Your Understanding

**Question 1**

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

**Solution**

The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

**Question 2**

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

**Solution**

Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

**Question 3**

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

**Solution**

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.



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### Correct/Incorrect

1. Sufficiency is the measure of the quantity of audit evidence. [SM]

Correct: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required).

2. Purchase invoice is an example of internal evidence. [SM]

Incorrect: Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

3. When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries. [SM]

Incorrect: When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the meaning of audit evidence in detail. (MTP Nov-23 + Nov-23)

**Solution**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

**Question 2**

Suniti, a CA student, is part of an engagement team conducting audit of a company TIM Private Limited. According to audit programme, she is responsible for verifying purchases and PPE items appearing in books of accounts from records/bills of company. Besides, she has also been entrusted responsibility to obtain written representation from management regarding carrying out of physical verification of inventories during the year. During course of her work, she finds that:

i) One purchase bill amounting to ₹ 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited.

ii) The management has refused to provide a written representation relating to physical verification of inventories during the year. She has brought it to knowledge of engagement partner who has decided to use lack of such a representation as audit evidence.

Discuss whether each of above constitutes audit evidence. State reasoning for your answer.

(MTP May'24)

**Solution**

Audit evidence comprises both information that supports and corroborates management's assertions and any information that contradicts such assertions. Purchase bill of ₹ 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited. Therefore, it is contradicting management's assertion relating to occurrence of such purchases. Hence, it constitutes audit evidence.

Further, the absence of information (for example, management's refusal to provide a requested representation) is used by auditor, and therefore, also constitutes audit evidence. In the given case,



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management has refused to provide a written representation relating to physical verification of inventories during the year. Therefore, absence of information is used by auditor and it also constitutes audit evidence.

**Question 3**

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement and also by the quality of such audit evidence. Obtaining more audit evidence, however, may not compensate for its poor quality. Explain also stating the factors affecting auditor's judgment as to sufficiency of audit evidence.

[RTP Nov-20 • MTP Apr-23]

**Solution**

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Auditor's judgement as to sufficiency may be affected by the factors such as:

i) Materiality
ii) Risk of materialmisstatement
iii) Size and characteristics of the population.

(a) Materiality may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(2) Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit.

This consists of two components described as follows at the assertion level

a. Inherent risk: The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
b. Control risk: The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(c) Size of a population refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger more heterogeneous populations, more evidence would be required.

**Question 4**

Discuss what is understood by "appropriateness" of audit evidence. (SM)

**Solution**

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which it is obtained.

**Question 5**

The reliability of audit evidence depends on its source, nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance. Although exceptions may exist few generalisations can be made about reliability of audit evidence. Considering above discuss such generalisations that can be made about the reliability of audit evidence. [MTP 1 Jan'25]

OR

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence.

[MTP Apr-22]

**Solution**

Reliability of Audit Evidence: As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).





- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

**Question 6**

The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence? [Nov-22]

**Solution**

Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(I) Risk assessment procedures; and

(II) Further audit procedures, which comprise:

i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and

ii. Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

(a) Inspection
(b) Observation
(c) External Confirmation
(d) Recalculation
(e) Reperformance
(f) Analytical Procedures
(g) Inquiry

**Question 7**

While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence. [RTP May-22]

**Solution**

Inquiry: As per SA 500 Audit Evidence: -



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i) Inquiry consists of seeking information of knowledgeable persons, financial and non - financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

ii) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

iii) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

iv) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

**Question 8**

CA K audited the books of accounts of E Ltd. for the financial year 2020-2021. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor and its reliability. [Dec-21]

**Solution**

Audit Procedure:

- Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.
- Example of inspection used as a test of controls is inspection of records for evidence of authorisation.
- Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such





documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

- In view of above, it can be concluded that CA K used Inspection as an audit procedure.

**Question 9**

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Explain with the help of examples. [RTP Nov-20]

**Solution**

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist.

Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

**Question 10**

In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ₹ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. [MTP Nov-21]

OR

Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor? [MTP I Sep'24]



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**Solution**

Certificate from a Management's Expert: In the given case, SMP Limited has provided a sum of 20 lakhs in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

**Question 11**

Sanjeev, an articled clerk in an audit firm, is part of an engagement team conducting audit of a company for year 2023-24. It is a small company having a turnover of about ₹25 crores. During the course of audit, he notices that senior team member has taken following approach for selecting items for testing reflected in financial statements to obtain audit evidence: -

- He has selected to test items debited under the head "Machinery repair & maintenance" as expenditure relating to it during year 23-24 has increased considerably as compared to last year.
- Out of purchases, he has selected to test purchases from related parties amounting to ₹ 5 crores.
- He has also selected to test all individual items of expenditure exceeding ₹5 lakhs.
- Besides, he has also selected amount of ₹0.50 lakhs debited under head "legal expenses" to know purpose of payment made to external legal counsel.

Sanjeev understands that senior team member is using "audit sampling" for selecting items for testing. Do you agree with him? Which risk is involved in above approach? Discuss with reasons. [MTP II May'24]

**Solution**

Audit Sampling refers to the application of audit procedures to less than 100% of items within a population relevant under the audit such that all sampling units (i.e. all the items in the population) have an equal chance of selection.

In the given situation, senior team member is not selecting items for testing by means of audit sampling. He is only selecting specific items from a population.





In accordance with SA 500, one of the means available to auditor for selecting items for testing is "by selecting specific items."

Specific items selected may include: -

- High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Therefore, Sanjeev's understanding is not proper. The above approach for selecting items for testing is subject to non-sampling risk.

Non-sampling risk is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like, erroneous conclusion may be reached due to some inappropriate audit procedure.

**Question 12**

M/s KLM & Co. Chartered Accountants, a partnership firm, while designing tests of controls and tests of details in MN Ltd. has to determine the items for testing that can be effective in meeting the purpose of the audit procedure. For this, they decided to select specific items from a population. State the factors that can be considered by the audit firm for selecting specific items from a population and also state the specific items that can be included for such testing. (May'24)

**Solution**

The auditor may decide to select specific items from a population.

In making this decision, factors that may be relevant include:

i) the auditor's understanding of the entity,
ii) the assessed risks of material misstatement, and
iii) the characteristics of the population being tested.

Specific items selected may include: -

- High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.



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- Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

**Question 13**

Manya Textiles is manufacturer of bed sheets, curtain cloths, other handloom items etc. having its plant at Panipat. Auditors SJ & Co. is having doubts over the reliability of information given to him as audit evidence. Also, auditors observed inconsistent information while conducting audit. Guide the auditor as to how they should proceed in the given situation. [RTP Nov-22]

**Solution**

If:

a. audit evidence obtained from one source is inconsistent with that obtained from another; or

b. the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

**Question 14**

Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors. (SM)

Systems which have a feature of audit trail inspires confidence in auditors.

- It helps auditors in verifying whether controls devised by the management were operating effectively or not.
- It aids in verification whether a transaction was indeed performed by a person authorised to do it.
- Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

## SA 501- "Audit Evidence—Specific Considerations for Selected Items"

### Inventory

**Question 1**

ABC Ltd is engaged in manufacturing of different type of yarns. On going through its financial statements for the past years, it is observed that inventory is material to the financial statements.

You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. [MTP May-20]





**Solution**

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:
(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
(ii) Observe the performance of management's count procedures;
(iii) Inspect the inventory; and
(iv) Perform test counts; and
(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

**Question 2**

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting. [RTP May-20 + SM]

**Solution**

Matters relevant in planning attendance at physical inventory counting include, for example:

a. Nature of inventory.
b. Stages of completion of work in progress.
c. The risks of material misstatement related to inventory.
d. The nature of the internal control related to inventory.
e. Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
f. The timing of physical inventory counting.
g. Whether the entity maintains a perpetual inventory system.
h. The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
i. Whether the assistance of an auditor's expert is needed.

**Question 3**

While performing statutory audit of Contra Industries Private Limited, a company engaged in manufacturing and assembling of LED lights, CA Varun has decided to attend physical inventory count process of the company on 30th and 31st March, 2024. The inventories are lying at three different locations - two such locations A and B are in one city and third location C is in another city. Further, company also sends inventories to some service providers for quality control and testing as such facilities are not available with the company. CA Varun is well-versed with this type of industry and has prepared

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a list of following matters which could be relevant to him in planning attendance at physical inventory count process for discharging his responsibilities in accordance with SAs: -

- Nature of inventories i.e. LED light components, parts, circuits, panels, body, WIP and finished packed LED lights
- Materiality of inventories at different locations A, B and C
- Stage of completion of work-in-progress · Maintenance of perpetual inventory system by company
- Materiality of inventories lying with service providers
- Timing of physical inventory counting i.e. year end

There are two important matters which do not find place in above list. Without considering these crucial matters, it would be difficult for the auditor to properly plan his attendance at inventory count process in accordance with relevant SA. Discuss such matters. (MTP May'24)

**Solution**

The list given in the question does not contain following important matters: -

- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting. The auditor has to evaluate management's instructions for recording and controlling physical inventory counting. It is important for the auditor to know beforehand how the inventory count will be conducted so as to assess its effectiveness.
- The nature of internal control related to inventories at different locations. It is possible that inventories at one location have unsatisfactory control leading to higher risk of material misstatement related to inventories at that particular location.

**Question 4**

Quality Products Limited is engaged in manufacturing of bicycles. As part of manufacturing activities, it sends raw material to some business entities and procures finished components from them. As on 31st March 2024 inventories lying with such business entities are material. Being statutory auditor of Quality Products Limited, how you will obtain sufficient appropriate audit evidence regarding existence and condition of inventories lying with such business entities? (RTP Sep'24)

**Solution**

In accordance with requirements of SA 501,"Audit Evidence- Specific Considerations for Selected Items", when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

a. Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
b. Perform inspection or other audit procedures appropriate in the circumstances.





Other audit procedure may include -

- Inspecting documentation regarding inventory held by third parties
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.

## Litigation & Claims

**Question 1**

Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose. [MTP Apr-21]

**Solution**

The auditor SPV & Co. shall design and perform audit procedures in order to identify litigation and claims involving the entity (Pachranga International Ltd) which may give rise to a risk of material misstatement, including:

i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.
ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
iii) Reviewing legal expense accounts.

**Question 2**

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company? (SM)

**Solution**

As per requirements of SA-501, If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

**Question 3**

CA Z, the auditor of MNO Ltd., during the course of audit, assesses a risk of material misstatements regarding the litigations and claims involving the company. CA Z is not convinced with the management's



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explanations regarding the status of the litigations or claims. It is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general enquiry. The auditor sent a letter of specific enquiry requesting the entity's external legal counsel to communicate directly with the auditor. List out the inclusions in the letter of specific enquiry.

In certain circumstances the auditor may judge it necessary to meet with entity's external legal counsel to discuss the likely outcome of the litigations or claims. What will be auditor's reporting responsibility if the management refuses to give permission to the auditor to communicate or meet with the external legal counsel? (May'24)

**Solution**

A letter of specific inquiry includes:

i) A list of litigation and claims;

ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

iii) A request that the entity's external legal counsel confirm the reasonableness of management's assessments anc provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. Further, if management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding, and the auditor is unable to obtain sufficient appropriate evidence by performing alternate audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705. Alternatively, if the auditor is able to perform alternate audit procedures and can obtain sufficient and appropriate audit evidence to resolve the issue, then he can give an unmodified opinion.

**Question 4**

SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances? [May-22]

**Solution**

Circumstances when becoming necessary to meet with external legal counsel: In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.





In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

i. The auditor determines that the matter is a significant risk.

ii. The matter is complex.

iii. There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

## Segment Information

**Question 1**

TRM Ltd. is a company engaged in manufacture of beauty products. It has hair care segment, skin care segment and kids' beauty products. The auditor wants to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework. Suggest the audit procedures in the given case. [MTP Nov-21]

**Solution**

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

(1) Obtaining an understanding of the methods used by management in determining segment information.

Further,

(i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

(ii) Where appropriate, testing the application of such methods; and

(2) Performing analytical procedures or other audit procedures appropriate in the circumstances.

**Question 2**

GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with r'ference to the relevant SA. [May-22]

**Solution**

As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of intersegment amounts.



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(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

## SA 505 External Confirmations

**Question 1**

Define the following :

(i) Positive confirmation request

(ii) Negative confirmation request

(iii) Non-response

(iv) Exception [RTP May-20]

**Solution**

- Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

**Question 2**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests. [RTP May-20]

OR

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper? [SM]

**Solution**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:





a. Determining the information to be confirmed or requested;

b. Selecting the appropriate confirming party;

c. Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

d. Sending the requests, including follow-up requests when applicable, to the confirming party.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

**Question 3**

What are the factors to be considered while designing a confirmation request? [Nov-12]

Factors to consider when designing confirmation requests include:

- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.
- The assertions being addressed.
- The method of communication [for example, in paper form, or by electronic mode (like e-mail) or other medium].
- Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

**Question 4**

CA Rohit is appointed as an auditor of Grace Ltd., he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level. [July-21]

OR

CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally, CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer. (MTP Sep'24)



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**Solution**

In accordance with SA 505, "External Confirmations", Auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

a. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
b. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
c. A very low exception rate is expected; and
d. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Therefore, view of CA X is not correct.

**Question 5**

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable? (SM)

**Solution**

In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.



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**Question 6**

CA P is the auditor of MN Ltd. While scrutinising the accounts of MN Ltd., he observed that the company had large volume of Trade payable outstanding in the Balance sheet as on 31st March, 2023 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd . refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing. (May'23)

**Solution**

If management refuses to allow the auditor to send a confirmation request, CA P should deal in this regard in the manner prescribed in SA 505 explained hereunder:

a. Inquire as to management's reasons for the refusal and seek audit evidence as to their validity and reasonableness;
b. Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
c. Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SA 705.

**Question 7**

During the audit of accounts for the year ended 31.03.2024, the auditor of FD Limited wanted confirmation from a Trade Receivable, which was outstanding for more than six months, amounting to ₹ 4,25,000/-. The auditor sent a Confirmation letter to the party requesting them to respond directly to him, whether or not they agree with the amount outstanding from them. That trade receivable confirmed to the auditor of FD Limited, that they were required to pay an amount of ₹ 4,20,000 to FD Limited as per their books of accounts. State and explain the type of Confirmation Request sent by the auditor and the course of action that he should take on the confirmation received from the trade receivable. [Sep'24]

**Solution**

Positive confirmation request: A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request or providing the requested information.

Exception - A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The exception needs to be assessed to the entire population after analyzing the reason for difference.

Facts of case

In the given situation, the auditor has sent the positive confirmation request for the amount of 4,25,000 to a trade receivable which was outstanding for more than 6 months, however, due to difference between information requested to be confirmed, or contained in the entity's records (i.e. 4,25,000), and information provided by the confirming party (i.e. 4,20,000) is forming situation of exception confirmation.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330 in case a response is indicating an exception.

The company should be asked to investigate and reconcile the discrepancy indicated by the confirming party.

## SA 510: Initial Audit Engagement Opening Balances

**Question 1**

The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?

[May-22 + MTP Apr-23 + SM]

**Solution**

Audit Procedure Regarding Opening Balances: The newly appointed auditor of BTN Ltd shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor of BTN Ltd shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

1. Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.
2. Determining whether the opening balances reflect the application of appropriate accounting policies; and
3. Performing one or more of the following:



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i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.

ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

**Question 2**

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures. (MTP May'24)

**Solution**

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period.

Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

**Question 3**

Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to Rs. 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. [MTP Oct-19]

**Solution**

Verification of Inventory: As per SA 510 "Initial Audit Engagements - Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements.

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date.

The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined.

The auditor is advised not to exclude the audit of closing inventory from his audit programme.

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*I'm glad you're doing that"*

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**Question 1**

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples. [RTP May'20 + Nov'23 + SM]

**Solution**

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

**Question 2**

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances. During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples. [MTP Sep'24 + RTP Nov-21 + MTP Nov-23]

**Solution**

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, for example:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.

7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g, prospectuses)

## SA 560 Subsequent Events

### Test Your Understanding

**Question 1**

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA PK Jacob should proceed to deal with above issue. [SM]

**Solution**

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements. He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

**Question 2**

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so. [SM]



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**Solution**

She has already performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

**3. Which of the following is not an example of subsequent event?**

(a) Event occurring between date of financial statements and date of auditor's report.
**(b) Event occurring on date of financial statements.**
(c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.
(d) Event occurring during course of performing audit procedures after date of financial statements.

### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

CA K is statutory auditor of DEMA Private Limited for the year 2022-23. The company has three plants in India. He is nearing completion of audit procedures relating to financial statements for the year under audit and has yet to sign audit report. Meanwhile, a huge fire had broken out in one of plants of the company located near Nashik on 25th June, 2023 damaging substantial part of machinery and work-in-process resulting in loss of about ₹ 5 crores. Unaware of the incident, he is in process of finalizing his report in first fortnight of July 2023.

State few audit procedures to be performed by him to obtain sufficient appropriate evidence for identifying such events. Also explain auditor's responsibilities in this situation. [MTP May'24 + July-21]

**Solution**

In the given situation, a huge fire had broken out in one of plants of company on 25th June, 2023 destroying substantial part of machinery and work-in-process resulting in loss of ₹ 5 crores. The auditor has yet to sign audit report.

Before signing audit report, he should perform following audit procedures to obtain sufficient appropriate audit evidence that all such events have been identified and are appropriately reflected in financial statements: -

- Inquiry of management whether any subsequent events have occurred
- Reading minutes of the meetings of owners, management that have been held after date of financial statements and inquiring about matters discussed at such meetings for which minutes are not available
- Reading entity's latest subsequent interim financial statements
- Obtaining Written representations from management in accordance with SA 580

The situation is an example of subsequent event occurring between date of financial statements and date of audit report requiring disclosure in financial statements. The auditor has a responsibility to obtain sufficient appropriate audit evidence whether such an event requiring disclosure in financial statements is appropriately reflected in financial statements.

**Question 2**

CA J is working as internal auditor in JKL Limited, a non-listed company. The responsibilities of internal auditor include reviewing financial information and performing detailed tests on transactions and balances. He is also responsible for compliance with laws, regulations and external requirements. During the year 2022-23, services of an employee of company were terminated. The said employee had filed a suit against the company in respect of certain compensation dues amounting to ₹ 10 lakhs which were not paid to him. Based upon advice of legal counsel, the company had made a provision of ₹ 10 lacs in financial statements for year 2022- 23. However, somewhere in June 2023, there is an out of court settlement between company and employee for ₹ 6 lakhs. The statutory audit of company is under progress and audit report has not yet been finalized. How internal auditor should have proceeded in situation?

[MTP II May'24]

**Solution**

Subsequent events are events occurring between the date of financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report. In the given case, the company had already made provision of ₹ 10 lakhs in financial statements for year 2022-23.

However, there is an out of court settlement between the company and employee for ₹ 6 lakhs. It is an example of event which provides evidence of conditions that existed at the date of financial statements i.e. 31st March, 2023. It provides evidence on adjustment in provision amount already made in financial statements.

Therefore, internal auditor should ask management to revise provision downwards to ₹ 6 lakhs so that financial statements are in accordance with applicable accounting standards.





**Question 3**

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation. [MTP Nov-21]

**Solution**

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

a. Discuss the matter with management and, where appropriate, those charged with governance.
b. Determine whether the financial statements need amendment and If so,
c. Inquire how management intends to address the matter in the financial statements.

**Question 4**

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events. [RTP Nov-21]

**Solution**

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements.

Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

(a) Those that provide evidence of conditions that existed at the date of the financial statements; and

(b) Those that provide evidence of conditions that arose after the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Subsequent events refer to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.



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**Question 5**

As per SA 560, when after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that had it been known to the auditor at the date of the auditor's report, it may have caused the auditor to amend the auditor's report. In this context, what is meant by "Date the financial statements are issued"? Can it be later than the date of providing auditor's report to the entity? (MTP Sep'24 + ICAI SM)

**Solution**

Meaning of "Date the financial statements are issued"

It reflects the date that the auditor's report and audited financial statements are made available to third parties.

- The date the financial statements are issued generally depends on the regulatory environment of the entity.
- In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority.
- Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Therefore, "date the financial statements are issued" can be later than date of providing auditor's report to the entity.

**Question 6**

CA Rashmi is the auditor of ABC Ltd. for the financial year ending 31/03/2024. The audit report for the year was signed by her on 19/04/2024. On 25/4/2024, the company received a communication from the Central Government that an incentive amount of ₹ 5 crores pertaining to financial year 2023-24 was approved. It was paid to the company before the end of April 2024. The financial statements of the company were not yet issued to the shareholders.

The Board of Directors wished to include the incentive amount in the financial statements and requested the auditor to issue a fresh audit report for the year ended 31/03/2024.

Analyze the issue involved and give an overview of the auditor's responsibility in such a situation.

**Solution** [Sep'24]

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued: As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.





However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

i) Discuss the matter with management and, where appropriate, those charged with governance.
ii) Determine whether the financial statements need amendment and, if so,
iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.

Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

Facts of Case

In the instant case, ABC Ltd. received an amount of ₹ 5 crore on account of incentives pertaining to year 2023-24 in the month of April 2024 i.e. after finalisation of financial statements and signing of audit report but before the issuance of Financial Statements to stakeholders. The Board of Directors of ABC Ltd. wished to amend the financial statements and requested the CA. Rashmi (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2024.

Conclusion

After applying the conditions given in SA 560, CA. Rashmi can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

## SA 570 Going Concern

### Test Your Understanding

**Question**

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages. Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company. How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation? (+MTP Jan'25)



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**Solution**

Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Stay fit Private Limited is a start-up that has been in business for about two years. It runs an application which provides valuable information pertaining to nutrition and helps its clients to access customized healthy food. The company's revenues are expected to grow in the coming period. Although company has reflected net losses in its financial statements for the last two years, it has managed to meet its financial commitments. The financial statements for last two years were prepared on going concern basis of accounting. The management of company wants to follow the same basis of accounting for the current year. Is the view of management appropriate? How does the "going concern" affect the preparation of financial statements? (MTP Sep'24)

**Solution**

As per SA 570, "Going Concern", going concern is one of the fundamental accounting assumptions.

- The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future.
- It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
- Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.
- General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.



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In the given situation, company has reflected net losses in financial statements of last two years but is able to meet its financial commitments signifying its ability to carry on business/trade. The revenue of company is also expected to grow in the coming period. It shows that management has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations.

Therefore, view of the management for following going concern basis of accounting in current year is appropriate.

Further, the significance of going concern is due to its effect on the preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

**Question 2**

Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions. What are relevant factors to that judgement? [Jan-21]

**Solution**

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

**Question 3**

As described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern. (RTP May-21)

**Solution**

The auditor's responsibilities are:

(1) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and

(2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions.

Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

**Question 4**

While doing audit of ABC Pvt Ltd, on the basis of sufficient and appropriate evidence, auditor comes to a conclusion that use of the Going Concern Basis of Accounting is appropriate, but a material uncertainty exists. Discuss the implications for auditor's report if:

(a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements

(b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

[RTP Nov-21 + May-23]

**Solution**

(A) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" " to: -

a. Draw attention to the note in the financial statements that discloses such matters.
b. State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

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(B) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

a. Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and
b. In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

**Question 5**

While conducting audit of BYN Limited, CA Y notices that company has lost one of its key markets along with important customers. Additionally, several highly successful competitors have emerged, impacting business of the company. Despite the existence of material uncertainty, CA Y finds the use of going concern basis of accounting appropriate for preparation of financial statements. The company has also disclosed material uncertainty in notes to accounts adequately. How should he deal with the matter in auditor's report? (RTP Sep'24)

**Solution**

As per SA 570,"Going concern", if adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" " to: -

a. Draw attention to the note in the financial statements that discloses such matters.
b. State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

**Question 6**

CA B is statutory auditor of Boom Payments Bank for year 2023-24. During the year, banking regulator has imposed restrictions on Bank from accepting new deposits due to non-compliance in conducting KYC in large number of accounts and violation of rules aimed at preventing money laundering. There is material uncertainty regarding probable outcome of such restrictions on ability of Bank to continue as going concern. However, for year 2023-24, auditor has concluded that use of going concern basis of accounting is appropriate. The financial statements of Bank do not make adequate disclosure of material uncertainty due to above events in financial statements. What are implications for auditor's report for year 2023-24 in view of above? (MTP May'24)

**Solution**

As described in the situation given in the question, banking regulator has imposed restrictions due to non-compliance with regulatory requirements and there is material uncertainty of such events or

conditions which may cast a significant doubt on ability of Bank to continue as going concern. However, the financial statements of Bank do not make adequate disclosure of material uncertainty due to above events in financial statements.

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

**Question 7**

Give examples of financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. [MTP May'24 + RTP Nov-21]

**Solution**

The following are examples of Financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern :

- ✓ Net liability or net current liability position.
- ✓ Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- ✓ Indications of withdrawal of financial support by creditors.
- ✓ Negative operating cash flows indicated by historical or prospective financial statements.
- ✓ Adverse key financial ratios.

**Question 8**

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case. Also explain how would the auditor proceed if such an assessment has not yet been performed by the management. (RTP May-21)

**Solution**

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:



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(i) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(ii) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

**Question 9**

During the audit of a company, CA Kartik has noticed that company's turnover has fallen drastically as compared to last three years due to loss of its major markets and key customers. The company is in need of funds for new product development, but bankers are not willing to lend financial support. Which additional audit procedures need to be performed by CA Kartik in accordance with SA 570 when such events or conditions are identified? (RTP Jan'25)

**Solution**

Loss of major markets, key customers and inability to obtain financing for new product development are examples of events or conditions that may cast a significant doubt on the entity's ability to continue as going concern.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.

<u>These procedures shall include:</u>

a. Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
b. Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
c. Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions: -
   i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
   ii) Determining whether there is adequate support for the assumptions underlying the forecast.

d. Considering whether any additional facts or information have become available since the date on which management made its assessment.
e. Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

**Question 10**

Kundan, a CA student, is part of an engagement team conducting audit of an entity. The audit procedures are nearing completion. He notices that engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. Keeping in view above, answer the following: -

i) Discuss likely purpose of engagement partner in the above situation. Elaborate upon significance of such testing being performed by engagement partner.
ii) State any two audit procedures in relation to cash flow forecast likely to be performed by engagement partner. (MTP May'24)

**Solution**

In the given situatior , the engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. The audit procedures are also nearing completion.

Therefore, purpose of engagement partner in requiring a cash flow forecast is to obtain sufficient appropriate audit evidence regarding and to conclude on appropriateness of management's use of going concern basis of accounting in preparation of its financial statements.
Further, his purpose is also to conclude on basis of audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast a significant doubt on ability to entity to continue as a going concern, and to report in accordance with SA 570.

The significance of testing going concern assumption is due to its effect on preparation of financial statements.

When the use of going concern is considered as appropriate, assets and liabilities are recorded on the basis that entity will be able to realize its assets and discharge liabilities in normal course of business.

In case it is not so viewed, financial statements are prepared on liquidation basis.

Hence, testing such an assumption provides evidence to auditor whether use of such assumption is appropriate or not.

Two audit procedures in relation to cash flow forecast likely to be performed

- Evaluate reliability of underlying data generated to prepare the forecast





- Determine whether there is adequate support for assumptions underlying the forecast

**Question 11**

The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario? [SM]

**Solution**

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.

In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

**MCQs**

Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?

(a) Adverse key financial ratios
(b) **Inability to invest in modernisation of plant**
(c) Inability to pay creditors on time
(d) Inability to pay salary of staff

## SA 580 Written Representations

**Question 1**

Explain the objectives of the auditor regarding written representations. [Jan-21 + MTP Oct-21]

**Solution**

The objectives of the auditor regarding written representation:

a. To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
b. To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and
c. To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

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**Question 2**

CA K is re-appointed as the auditor of B Ltd. He wants to re-confirm certain matters and has asked the management to give written representations for the same. Under what circumstances can an auditor ask the management to reconfirm its acknowledgement and understanding of responsibilities in written representation? [Dec-21]

**Solution**

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor, CA K of B Ltd, may also ask management of B Ltd to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when:

a. Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
b. The terms of the audit engagement were prepared in a previous year;
c. There is any indication that management misunderstands those responsibilities; or
d. Changes in circumstances make it appropriate to do so.

**Question 3**

The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.
Discuss how would you deal as an auditor.

OR

"Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal". Discuss. [SM]

**Solution**

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters to support other audit evidence to confirm certain matters or provided to the auditor written statement by management with which they deal.

Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.





Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

**Question 4**

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to? (SM)

**Solution**

The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities.

This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

**Question 5**

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in the preparation of the financial statements providing the relevant information and also informing about completeness of transactions. Explain. [MTP II May'24]

**Solution**

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement. Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.



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(II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

i) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and

ii) All transactions have been recorded and are reflected in the financial statements.

**Question 6**

The management of PQ Ltd. changed during the period under audit. Mr. G an auditor, at the time of receiving written representation on the management responsibilities from the management, was in a dilemma related to the date of and period(s) covered by the written representation. Further, new management was of the view that they can give written representation from the date they took over and not for the prior period when old management were managing affairs of the company. Guide the auditor & the management in this respect. (May'24)

**Solution**

As per SA 580, "Written Representations", the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole.

Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

In view of above, management is required to provide the written representation for all the periods even when current management were not present during all periods referred to in the auditor's report.



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**Question 7**

CA Manoj is the statutory auditor of a company. He has completed the audit and issued the audit report dated June 30, 2024. Before signing the audit report, written representations dated June 29, 2024, were obtained from the management of the company. Discuss the significance of the date of written representations. Also state whether the written representations obtained on June 29, 2024 is appropriate or not. (RTP Sep'24)

As per SA 580,"Written Representations" the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.

Since written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations.

Furthermore, because the auditor must consider events occurring up to the date of the auditor's report that might require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, CA Manoj obtained written representations dated June 29, 2024, from the management of the company before signing the audit report on June 30, 2024.

From the above is can be concluded that written representations have been obtained appropriately.

**Question 8**

During the audit of a company, CA Jack obtained written representations from management regarding all known instances of non-compliance with laws and regulations that should be considered in the preparation of the financial statements. However, during the audit, he observed that the information provided in this regard was incomplete, and the audit evidence indicating such non-compliance contradicted the written representations, casting doubt on their reliability. How should CA Jack proceed in this situation? (MTP I Jan'25)

**Solution**

In the given situation, company's management has not provided complete information regarding instances of non-compliance with laws & regulations. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.

The above situation highlights that auditor has obtained audit evidence relating to non-compliance with laws which is inconsistent with written representations in this respect casting a doubt about reliability of written representations.

As per SA 580, "Written Representation", if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter.

If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report" having regard to the requirement of disclaimer of opinion.

**Question 9**

Akash & Associates are the statutory auditors of Deluxe Ltd. for the FY 2020-21. During the course of audit, CA Akash, the engagement partner requested the management of the company to provide written representation with respect to valuation of a transaction. The management, however does not provide the same to CA Akash. What course of action should CA Akash follow in such situation? [MTP Mar-23]

**Solution**

If management of Deluxe Ltd. does not provide one or more of the requested written representations, CA Akash should:

a. Discuss the matter with management;
b. Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
c. Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

**MCQs**

Written representations are: -

**(a) Necessary audit evidence**
(b) Sufficient appropriate audit evidence
(c) Not audit evidence
(d) Audit evidence depending upon auditor's professional judgment

*"You are like a Flower, one day you'll Blossom,*
*keep watering your Destiny with Hardwork"*



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**Question 1**

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories. He points it out to the management in a one-liner as under: -

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

In view of above, please explain:

(i) What is meant by deficiency in internal control?

(ii) Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard. (SM + MTP May'24 + Sep'24)

**Solution**

(i) Deficiency in internal control –

This exists when: -

a. A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or
b. A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(ii) While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper.

Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company.

Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

**Question 2**

List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency". (SM + MTP Sep'24)

**Solution**

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
  - ✓ General monitoring controls (such as oversight of management).
  - ✓ Controls over the prevention and detection of fraud.
  - ✓ Controls over the selection and application of significant accounting policies.
  - ✓ Controls over significant transactions with related parties.
  - ✓ Controls over significant transactions outside the entity's normal course of business.
  - ✓ Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

**Question 3**

In what ways an effective two-way communication between auditor and those charged with governance is important? (SM)

**Solution**

An effective two-way communication is important in assisting: -

a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.
b. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
c. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.



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**CASE STUDY**

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter. The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

**Based on above, answer the following questions: -**

**(1) As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?**

a. The auditor should express an unmodified opinion.
b. The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
c. Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.
d. Such an issue does not affect auditor's opinion.

**(2) As regards going concern basis of accounting is concerned, which of the following statements is true?**

a. A company showing net loss in its financial statements is essentially not a going concern.
b. Following going concern assumption of accounting is primary duty of auditor.
c. In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.

d. Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.

**(3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?**

a. There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.
b. There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.
c. The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.
d. The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.

**(4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?**

a. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
b. Written representations should be unconditional. Such a wording is not acceptable.
c. Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
d. Qualifying language in written representations is compulsory.

**(5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?**

a. Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
b. Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.
c. Matters communicated orally need not be put into writing. It is not practically feasible.
d. Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

1. c 2. c 3. d 4. a 5. a



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**An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?**

(a) Evaluation of adequacy of communication process is required on part of the auditor.
(b) Planned scope and timing of audit has also to be communicated.
(c) **Communication of rationale behind audit procedures is necessary.**
(d) Significant difficulties encountered during audit, if any, have to be communicated.

## Test your Understanding

**Question**

An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.

**Solution**

Analytical procedures in relation to revenue can include:-

(i) Comparing revenue of current year with previous year and investigating significant fluctuations

(ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations

### Correct/Incorrect (SM)

1. As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.

Incorrect. As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data.

2. Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.

Incorrect. Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

3. Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

Incorrect. Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

4. Analytical Procedures are required in the planning phase only.





Incorrect. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

5. Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time

Incorrect. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time

6. Ratio analysis is useful in analyzing revenue and expense account only.

Incorrect: Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

7. Reasonableness test rely only on the events of the prior period like other analytical procedures.

Incorrect: Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

8. The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.

Incorrect: Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Explain giving examples of both. [RTP Nov-21 + Nov'22]

**Solution**

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

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Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

**Question 2**

Tree Limited presented its financial statements for the F.Y. 2021-2022 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons? [May-22]

**Solution**

Purpose of Applying Analytical Procedure: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Tree Ltd. Would achieve the following by carrying out the comparison stated in the question:

i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.

ii) By setting up certain expenses' ratios on basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

**Question 3**

Whether it is possible to independently verify the correctness of some of the items of expenses included in the statement of profit and loss? Explain with the help of some examples. [Dec-21]

**Solution**

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

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- For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.
- Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.
- Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.
- Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

**Question 4**

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit. [MTP Nov-21]

**OR**

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain. [RTP Nov-20]

**Solution**

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

- Analytical Procedures in Planning the Audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware.
- This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.
- Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.
- For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

**Question 5**

The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain [RTP Nov-20]

**Solution**

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

**Question 6**

With respect to SA 520 "Analytical procedures", explain the following factors to be considered by the auditor for substantive audit procedures.
(i) Account type (ii) Predictability (iii) Nature of Assertion. [Nov-20]

**Solution**

The auditor should consider the following factors for Substantive Audit Procedures:

Account Type - Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

Predictability - Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

Nature of Assertion - Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/ measurement and occurrence.

**Question 7**

CA M, auditor of a company, has planned to use substantive analytical procedures during course of audit. In this regard, he has decided to use such procedures in following areas: -
(i) For testing relationship between sales and cost of sales
(ii) For testing rights over certain assets forming part of account balances





Comment upon his approach along with reasons. (MTP Sep'24)

**Solution**

(i) Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable. A predictable relationship is one that may reasonably be expected to exist and continue over time. In the given case CA M, auditor of a company, has planned to use substantive analytical procedures for testing relationship between sales and cost of sales. Hence, auditor's approach is appropriate in this case.

(ii) Using substantive analytical procedures is also affected by nature of assertion. Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). In the given case, CA M has planned to use substantive analytical procedures for testing rights over certain assets forming part of account balances. Such procedures are likely to be less effective in this case.

**Question 8**

While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence? [SM]

**Solution**

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis - Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis - Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests - Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In

other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

**Question 9**

Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. [RTP May-20]

**Solution**

Trend analysis

Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

- The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- In other words, trend analysis implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

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**Question 10**

Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in combination with test of details, as substantive procedures in accordance with SA 330. [RTP Nov'22]

**Solution**

Analytical procedures used as substantive tests: When designing and performing substantive analytical procedures, either alone or in combination with test of details as, substantive procedures in accordance with SA 330, the auditor shall:

i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.

ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.

iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.





iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

**Question 11**

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain [MTP May-22]

**Solution**

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

- The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
- However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.
- The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

**Question 12**

Discuss with examples the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. [RTP Nov-22 + May-23]

**Solution**

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

**Question 13**

Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated. [RTP May-22]

**Solution**

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.
For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.
For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

**Question 14**

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences. [MTP Nov-23 + Nov-23]

**Solution**

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:



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(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

"Basis my Analytical Procedures,
you are on RIGHT TRACK to CLEAR the Exams"

## Case Study

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients.

You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

Based on above, answer following questions:

**1. In case of M/s Persistent & Company, what would be an ideal Audit Opinion?**
(a) Unmodified
(b) Qualified
(c) Mention the fact in Emphasis of Matter Paragraph
(d) Disclaimer

**2. In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?**
(a) Qualified
(b) Adverse
(c) Disclaimer
(d) Unmodified

**3. According to you, what would be appropriate course to take in case of M/s Honest & Associates?**
(a) Issue Qualified Opinion
(b) Issue Adverse Opinion
(c) Mention the fact of change in method in Emphasis of Matter Paragraph





**4. When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?**
(a) Issue Unmodified Opinion
(b) Issue Qualified Opinion
(c) Issue Disclaimer of Opinion
(d) Mention it in Emphasis of Matter Paragraph

**5. When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:**
(a) Modified Opinion
(b) Qualified Opinion
(c) Disclaimer of Opinion
(d) Unmodified Opinion

1. (b) 2. (c) 3. (c) 4. (b) 5. (d)

## MCQs based Questions

**1. While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?**
(a) present fairly in all material respects
(b) give a true and fair view
(c) with the foregoing explanation
(d) All of the above

**2. ..... is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.**
(a) Emphasis of Matter Paragraph
(b) Other Matter Paragraph
(c) Key Audit Matter
(d) Management Responsibility Paragraph.

**3. Statement 1:** Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.
**Statement 2:** Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.

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(a) Only Statement 1 is correct
(b) Only Statement 2 is correct
(c) Both the statements are correct
(d) None of the statement is correct

**4. Which of the following is not correct?**
(a) SA 700 - Forming an Opinion and Reporting on the Financial Statements
(b) SA 701- Key Audit Matters in the Independent Auditor's Report
(c) SA 705- Comparative Information- Corresponding figures and Comparative Financial Statements
(d) SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

**5. Responsibilities of Joint Auditors are governed by:**
(a) SA 200
(b) SA 229
(c) SA 299
(d) SA 230

1. (c) 2. (a) 3. (d) 4. (c) 5. (c)

## SA 700 "Forming an Opinion & Reporting on Financial Statements"

### Test Your Understanding

**Question 1**

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only? (+RTP Jan'25)

**Solution**

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs. It is required to be stated in case of audit reports and certificates.

**Question 2**

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting





para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

**Solution**

"Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion. Therefore, Sana's thinking is not proper.

**Correct/Incorrect**

1. In considering the qualitative aspects of the entity's accounting practices, the auditor may not become aware of possible bias in management's judgments. [RTP Nov-20]

Incorrect: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

2. The Location of the description of the auditor's responsibilities for the audit of the financial statements is always within the body of the auditor's report [July-21]

Incorrect: The description of the auditor's responsibilities for the audit of the financial statement shall be always shown as below -

- Within the body of the auditor's report
- Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or
- By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

3. There is no need of addressee in the Auditor's report. [SM]

Incorrect: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

4. The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework

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Incorrect: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain. [RTP May-21]

**Solution**

- ✓ The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users.
- ✓ This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.
- ✓ Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards.
- ✓ It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

**Question 2**

"The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework." Explain [SM]

OR

M/s S & Associates are the Statutory Auditors of Real Ltd., a company engaged in the business of manufacturing of garments. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2024-2025. CA K, the engagement partner, wants to conclude that whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach that conclusion?

[MTP May'24 + Dec-21]

**Solution**

Factors to be considered to form an opinion:

- ✓ The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
- ✓ In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.



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That conclusion shall take into account:

(a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained

(b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate.

(c) The evaluations required

i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

**Question 3**

The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's accounting practices. [SM + MTP Mar-19]

**Solution**

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

**Question 4**

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required. [SM + RTP May-20]

**Solution**

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit.

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

**Question 5**

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Explain stating clearly specific evaluations made by the auditor. (SM + RTP May-22 + MTP Oct-21/Mar-23)

**Solution**

In particular, the auditor shall evaluate whether:

a. The financial statements adequately disclose the significant accounting policies selected and applied;
b. The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
c. The accounting estimates made by management are reasonable;
d. The information presented in the financial statements is relevant, reliable, comparable, and understandable;





e. The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
f. The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

(a) The overall presentation, structure and content of the financial statements; and
(b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

**Question 6**

M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2021- 22. How will the auditor address the audit report issued on the financial statements for the FY 2021-22? Also give a title to the report. (SM)

**Solution**

INDEPENDENT AUDITOR'S REPORT

To the Members of Hotmeals Ltd.

**Question 7**

Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. Explain how the statutory auditor of the firm will address the auditor's report. (SM)

**Solution**

INDEPENDENT AUDITOR'S REPORT

To the Partners of Richa International

**Question 8**

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section. [SM + RTP Nov-22]

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**Solution**

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion".

Opinion Section of the Auditor's report shall also:

i) Identify the entity whose financial statements have been audited;
ii) State that the financial statements have been audited;
iii) Identify the title of each statement that comprises the financial statements;
iv) Refer to the summary of significant accounting policies and other explanatory information; and
v) Specify the date or period covered by each financial statement comprising the financial statements.

**Question 9**

M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2021-22. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report. (SM)

**Solution**

Opinion

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2022 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

**Question 10**

CA Ayush has recently qualified and has joined a CA Firm. On going through various audit reports, he observed that different phrases were used to express an unmodified opinion on the financial statements. On enquiring with a senior, he got to know that all those phrases can be regarded as being equivalent. Which phrases are appropriate and which phrases are inappropriate while drafting an unmodified opinion? [Sep'24]

**Solution**

Appropriate and Inappropriate Phrases while drafting an Unmodified Opinion: When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:





i) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework]; or
ii) In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework].

The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent.

Inappropriate Phrases: When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

**Question 11**

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section. [SM]

**Solution**

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

a. States that the audit was conducted in accordance with Standards on Auditing;
b. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
c. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
d. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

**Question 12**

M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2021-22. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section. (SM)

**Solution**

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described



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in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Question 13**

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." Give a brief description about management's responsibilities in the auditor's report as it helps to explain the users the premise on which an audit is conducted. Also state the requirement specified in Standard on Auditing 210 for the auditor to agree management's responsibilities. [Nov'23 + SM]

**Solution**

"Responsibilities of Management for the Financial Statements" section of the auditor's report shall describe management's responsibility for:

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a. Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement &
b. Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

SA 210 requires the auditor to agree the management's responsibilities in an engagement letter or other suitable form of written agreement.

**Question 14**

Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report. (SM)

**Solution**

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial





statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act.

This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

**Question 15**

M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2021- 22. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member. (SM)

**Solution**

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

**Question 16**

M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same. (SM)

**Solution**

The following is the correct way of signing an audit report.

M/s TUV & Associates
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)
Place of Signature: UDIN: 20037320AAAAAH1111
Date:

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## SA 701 "Communicating Key Audit Matters in the Independent Auditor's Report"

**Correct/Incorrect**

Communicating Key Audit Matters is a substitute for the auditor expressing a modified audit opinion when required by the circumstances of a specific audit engagement in accordance with SA 705. [Jan-21]

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised)

**Past Exams/RTPs/MTPs/SM Questions**

**Question 1**

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, explain the areas of concern that an auditor should take into account. [Nov'23] OR

As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters". [MTP Oct-21]





**Solution**

Determining Key Audit Matters: As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit.

In making this determination, the auditor shall take into account the following:

i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

**Question 2**

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not considered as a substitute or alternative for a number of important items. What are those items? (SM + RTP Nov'23)

**Solution**

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole.

Communicating key audit matters in the auditor's report is not:

i) A substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

iv) A separate opinion on individual matters.

## Test Your Understanding

**Question 1**

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

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**Solution**

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive. In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

**Correct/Incorrect**

1. The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

Incorrect: The auditor shall modify the opinion in the auditor's report when:

a. The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
b. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.





2. The auditor shall express a disclaimer of opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Incorrect: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

3. When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.

Incorrect: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report". [SM + MTP II May'24]

**Solution**

As per Standard on Auditing (SA) 705 "Modifications to the Opinion In The Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

**Question 2**

"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." Briefly explain when the auditor should express: (i) Qualified Opinion. (ii) Adverse Opinion and (iii) Disclaimer of Opinion. (MTP I Jan'25)

**Solution**

"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." The auditor should consider the following while expressing the opinion in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

(i) Qualified Opinion

- The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, are material, but not pervasive or
- The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iii) Disclaimer of Opinion: The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and he concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

**Question 3**

Elucidate the circumstances when a modification to the Auditor's opinion is required. Also state the factors for making the decision regarding which type of modified opinion is appropriate. (SM + May23)

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**Solution**

Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The decision regarding which type of modified opinion is appropriate depends upon:

a. The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

b. The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

| Nature of Matter Giving Rise to the Modification | Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Statements | |
|---|---|---|
| | Material but not Pervasive | Material and Pervasive |
| Financial statements are materially misstated | Qualified opinion | Adverse opinion |
| Inability to obtain sufficient appropriate audit evidence | Qualified opinion | Disclaimer of opinion |





**Question 4**

While conducting audit of VED Ltd., you as an auditor are not only prevented in completing certain audit procedures but also are not able to obtain audit evidence even by performing alternative procedures. How you will deal with this situation? [MTP Apr-22]

**Solution**

As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

1. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
2. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
   (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
   (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If auditor withdraws, before withdrawing, auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

**Question 5**

CA. S, while conducting audit of an entity is facing the following issues: -

i) He has not been provided with necessary support for attending inventory count process of entity as at year end.

ii) Accounts Manager is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.
iii) He was not able to verify revenues of entity due to lack of complete details.
iv) He has been asking for bills on a sample basis for the purpose of verifying expenses, but staff has been making lame excuses. The matter was brought to knowledge of higher management, but of no avail.

The auditor, CA S has come to the conclusion that the possible effects on the financial statements of undetected misstatements would be material and affecting many aspects of financial statements and in such a case, a qualification of the opinion would be inadequate to communicate the gravity of the situation. How should the auditor proceed in such a situation? [RTP May'24]

**Solution**

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter was brought to the knowledge of management but no result has been achieved. In such circumstances, auditor should proceed as given here under: -

If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If auditor withdraws from such an engagement, before withdrawing, auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

**Question 6**

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020- 21 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive. Explain the kind of audit report that the statutory auditor of the company should issue in this case. (SM + RTP Nov'21)





**Solution**

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In the present case Delightful Ltd, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. Moreover, the auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

**Question 7**

What an auditor should state in "Basis for opinion" section of auditor's report and when the auditor modifies the opinion on the financial statements, what amendments he should make in this section ?
[Jan-21 + RTP Nov'20]

**Solution**

An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

i) States that the audit was conducted in accordance with Standards on Auditing;
ii) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
iv) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Amendments an Auditor should make :

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

(i) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
(ii) Within this section, include a description of the matter giving rise to the modification.

**Question 8**

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700. Explain. (RTP May-22 + July-21)

**Solution**

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

a. A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
b. A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
c. The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

**Question 9**

M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the F.Y. 2021-22. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2022. The cash balance of the company as on 31.03.2022 is ₹ 1,00,000/- and the turnover of the company for the year is ₹ 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

**Solution**

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion.

**Question 10**

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion. [SM]





**Solution**

An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive. Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 - "Modifications To The Opinion In The Independent Auditor's Report" deals with the form and content of both types of report.

The following are the draft of the opinion paragraphs of the reports.

(a) Adverse Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2021, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

(b) Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2021, and the statement of Profit and Loss. (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)).

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles

generally accepted in India, of the state of affairs of the Company as at March 31st, 2021 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

**Question 11**

M/s Taj Raj & Associates are the statutory auditors of Polex Ltd. engaged in the manufacture of premium watches, for the FY 2021-22. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2022. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj. (SM)

**Solution**

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

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Facts of Case:

In the case Polex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements.

Conclusion:

As such, CA Taj should give an adverse opinion. Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

**Question 12**

Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2021- 22. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material. Explain the type of opinion that should be given by M/s Young Old & Associates in this case. (SM)

**Solution**

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.





**Question 13**

M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. For the FY 2021-22. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance. (SM)

**Solution**

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

**Question 14**

M/s ABC & Associates, statutory auditors of Opaque Ltd., are in the process of finalizing the audit report of the company but in view of their inability to obtain sufficient appropriate audit evidence, they would like to disclaim their opinion on the financial statements. Explain reporting responsibilities of M/s ABC & Associates pursuant to SA 700 (Revised). How they will address key audit matters section in accordance with SA 701 when they are expressing disclaimer of an opinion on the financial statements? [Nov'23]

**Solution**

SA 700 requires that if the auditor is unable to obtain sufficient appropriate audit evidence to conclude that financial statements as a whole are free from material misstatements, the auditor shall modify opinion in accordance with requirements of SA 705.

SA 705 requires that when the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

i) State that the auditor does not express an opinion on the accompanying financial statements;
ii) State that, because of the significance of the matters described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
iii) Amend the statement required by SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Alternative Solution

When an auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

i) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

ii) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

iii) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

SA 705 requires that unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

## SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report"

### Correct/Incorrect

1. The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion. [MTP Mar-21]

Incorrect: When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall Indicate that the auditor's opinion is not modified in respect of the matter emphasized. Such a paragraph shall refer only to information presented or disclosed in the financial statements. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

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### Past Exams/RTPs/MTPs/SM Questions

**Question 1**

State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph. [MTP Oct-20]

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

a. A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
b. As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.





Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

**Question 2**

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report? [RTP Nov-20]

**Solution**

Definition covered in Ques 1

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

**Question 3**

D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is fundamental to the users understanding, CA P has decided to communicate the same in his report. CA P seeks your guidance in reporting this matter in his audit report. (May-22)

**Solution**

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

i) The auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter; and
ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

In the given case as the properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only, hence there is a need to add Emphasis on Matter Paragraph in the Auditor's Report.

The draft of the same is as under:

Emphasis of Matter - Effect of Properties obtained through barter deals by the company

We draw attention to Note (Y) of the financial statements, which describes the effects of the properties obtained through barter by the company. Our opinion is not modified in respect of this matter.

**Question 4**

Pure Services Limited is into the litigation relating to some legal action initiated by the industry regulator. The matter has reached jurisdictional High Court. Keeping in view uncertainty related to future outcome of matter, statutory auditor of the company has decided to include Emphasis of Matter (EOM) Paragraph in auditor's report.

i) Briefly discuss the considerations to be taken care of by the statutory auditor when EOM paragraph is included in auditor's report.

ii) State any two examples of circumstances where the auditor may consider it necessary to include an EOM paragraph. (MTP Sep'24)

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**Solution**

When the auditor includes an Emphasis of Matter (EOM) paragraph in the auditor's report, the auditor shall:-

a. include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter"

b. include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements and

c. indicate that the auditor's opinion is not modified in respect of the matter emphasized.

(ii) Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter (EOM) paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.





**Question 5**

Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2021-22. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2022. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report. (SM)

**Solution**

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report.

The draft of the same is as under:

Emphasis of Matter - Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

## SA 710 "Comparative Information – Corresponding Figures & Comparative Financial Statements"

**Question 1**

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. Explain clearly stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information. (RTP Jan'25/May-19 + Nov-23)

**Solution**

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.

There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

a. For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

b. For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Definition of Comparative information - The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Audit Procedures regarding comparative information

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

a. The comparative information agrees with the amounts and other disclosures presented in the prior period; and
b. The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560.

@shubhamkeswani

As required by SA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

**Question 2**

The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances? [May-22]

**Solution**

Audit reporting Regarding Corresponding Figures: When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.





In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

a. Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
b. In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. Prior Period Financial Statements Not Audited- If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

**Question 3**

NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2021-2022. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2021. What will be the reporting responsibility casted on CA N when he forms an opinion and prepares audit report on the Comparative Financial Statements for the F.Y. 2021-2022?

Prior Period Financial Statements Audited by a Predecessor Auditor: As per SA 710, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, CA. N, the auditor of NG Limited shall state in an Other Matter paragraph:

a. That the financial statements of the prior period were audited by a predecessor auditor
b. The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor and
c. The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

**Question 1**

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue. (SM)

**Solution**

As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.

Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

**Question 2**

ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report. [SM]

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**Solution**

Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.





Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

**Question 3**

Mr. L is a principal auditor of OP Ltd. There are several divisions of OP Ltd. that are audited by other auditors. State the procedures Mr. L should ordinarily perform to obtain sufficient and appropriate audit evidence that the work of other auditors is adequate for the principal auditor's purpose in the context of this assignment. (May'24)

**Solution**

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.

When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

i) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and

ii) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

iii) The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor.

## SA 299 "Joint Audit of Financial Statements"

**Question 1**

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard. [SM + MTP Sep'24]

**Solution**

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.

In developing the joint audit plan, the joint auditors should:

a. identify division of audit areas and common audit areas;

b. ascertain the reporting objectives of the engagement;

c. consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
d. consider the results of preliminary engagement activities, or similar engagements performed earlier
e. ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

**Question 2**

In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him". Discuss. [SM]

OR

HMB Limited's business has grown from one state of India to various 4 countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible? [Nov-22]

**Solution**

In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.

On the other hand, all the joint auditors shall be jointly and severally responsible for:

- the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- presentation and disclosure of the financial statements as required by the applicable financial reportingframework;
- ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

**Question 3**

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit. [SM + MTP Apr-23]





**Solution**

Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

- Sharing of expertise.
- Advantage of mutual consultation.
- Lower workload.
- Better quality of performance.
- Improved service to the client.
- In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- Lower staff development costs.
- Lower costs to carry out the work.
- A sense of healthy competition towards a better performance.

*"Hard Work is like Gajar ka Halwa,*
*May Take time,*
*but Results are Sweet"*

@intermediatenotes

**Question 1**

Mr. Chetan is appointed as an auditor of Spot Limited, a small company. Mr. Chetan is aware that CARO 2020 is not applicable to small company. List out the classes of companies that are specifically exempt from the applicability of CARO 2020. [MTP I Sep'24 + SM]

**Solution**

CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except-

i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
ii) an insurance company as defined under the Insurance Act,1938;
iii) a company licensed to operate under section 8 of the Companies Act;
iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and
v) a private limited company, not being a subsidiary or holding company of a public company, having a
- paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and
- which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and
- which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

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**Question 2**

G Pvt. Ltd. had fully paid up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2024-2025. During the F.Y 2024-2025, company incurred losses to the tune of ₹ 25 lacs. During the year, the company also borrowed ₹ 55 lakh each from a bank and a financial institution independently. It had a turnover of ₹ 850 lakh (other than revenue of ₹ 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company. [May-22]

**Solution**

Applicability of CARO, 2020 in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company except-a private limited company, not being a subsidiary or holding company of a public company,

(i) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date; and

(ii) which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year; and





(iii)which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover (including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)) ₹ 1100 Lakh i.e., ₹ 11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

Author's comment: Since previous year figures not given, hence we have ignored small company provision.

**Question 3**

State the auditor's reporting responsibilities under CARO 2020 when -
(i) The company has raised money by public issue.
(ii) The company has made private placement of shares. [SM + Jan-21]

**Solution**

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

(i) whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

(ii) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance.

**Question 4**

UVW Ltd. a biopharma company and global manufacturers of select critical care medical products has been sanctioned working capital limits of ₹ 5.99 crores from a nationalized bank on the basis of security of current assets. During the year under audit, the statutory auditor of UVW Ltd. considers that inventory is material to the financial statements and performs audit procedures over the company's final inventory records to determine whether they accurately reflect actual inventory count and without any

major discrepancies for each class of inventory. What are the reporting requirements under CARO 2020 in this case? [Nov23] OR

State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits. [RTP May-22]

**Solution**

Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

a. whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

b. whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

**Question 5**

TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case? [RTP Nov-20 + Nov-22]

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**Solution**

Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

Facts of case

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilisation of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Conclusion:

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per clause (x)(b) of Para 3 of CARO, 2020.





**Question 6**

M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how will you include the above items in paragraph 3 of CARO, 2020? [Nov-19]

**Solution**

Clause (iii) of paragraph 3 of CARO, 2020 states

whether during year Co. has made investments in, provided any guarantee or security or granted any loans or advances in nature of loans, secured or unsecured, companies, firms, LLPs or any other parties, if so,-

a. whether during year Co. has provided loans or provided advances in nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-
   i. aggregate amt during year, and balance o/s at BS date w.r.t. such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;
   ii. Agg. amt during year, and balance outstanding at BS date w.r.t such LAGS to parties other than subsidiaries, joint ventures and associates;

b. whether investments made, guarantees provided, security given and T&Cs of grant of all loans and advances in nature of loans and guarantees provided are not prejudicial to the company's interest;

c. in respect of loans and advances in nature of loans, whether schedule of repayment of principal and payment of interest has been stipulated and whether repayments or receipts are regular;

d. if amount is overdue, state total amount overdue for more than 90 days, and whether reasonable steps have been taken by company for recovery of principal and interest;

e. whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and percentage of aggregate to total loans or advances in the nature of loans granted during year [not applicable to companies whose principal business is to give loans];

f. whether company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in Sec 2(76) of Companies Act, 2013;

2. Further, Clause (v) of paragraph 3 of CARO, 2020 states in case the company has accepted deposits,

i) whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any: ether relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;

ii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2020.

Author's comment: Since loan to related party, reporting can be done in clause (xiii) also.

**Question 7**

Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report. [Nov-22]

**Solution**

Incorrect: The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, "whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with".

**Question 8**

DOX Limited, a service provider company engaged in providing courier services pan-India as well as internationally, has appointed an internal auditor, Mr. G, in accordance with requirements of the Companies Act, 2013 during financial year 2023-24. The company's annual turnover during year 2022-23 and 2023-24 has been about ₹ 300 crores during each of above years. Business of the company has been profitable. Mr. G heads internal audit department of the company assessing governance activities, assisting in improving risk management activities and reviewing controls. Discuss reporting responsibility of statutory auditor of the company under the Companies Act, 2013 specifically in relation to internal audit and related matters for the year 2023-24. [MTP I May'24]

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**Solution**

DOX Limited is in business of providing courier services.

As name of the company and given facts suggest: -

- It is not a small company under section 2(85) of Companies Act, 2013.
- It is not a private company.
- It is not a one person company.
- It is not a banking or insurance company.
- It is not a Section 8 company as it does not has charitable objects etc.

Therefore, it does not qualify for any exemption from applicability of CARO, 2020. Hence, reporting requirements under CARO, 2020 are applicable.





While reporting under CARO, 2020, statutory auditor is required to report under clause (xiv) of paragraph 3 as under:

a. whether the company has an internal audit system commensurate with the size and nature of its business
b. whether the reports of the internal auditors for the period under audit were considered by the statutory auditor

**Question 9**

You have been appointed as the statutory auditor of a limited company. The company is registered as a Nidhi company. What are the reporting requirements of a Nidhi company under the Companies Auditor's Report Order, 2020? [May'24]

Reporting requirements of a Nidhi Company under the CARO 2020: The auditor is required to report under clause (xii) of Paragraph 3 of CARO 2020:

a. whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;
b. whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
c. whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof.

**Question 10**

During the audit of a limited company as a statutory auditor you discovered that a fraud amounting to ₹ 5 lakh has been committed by the company. What are the reporting requirements regarding fraud under the Companies Auditor's Report Order, 2020? [MTP I Jan'25]

**Solution**

Reporting requirements of a fraud under the CARO 2020: The auditor is required to report the fraud under clause (xi) of Paragraph 3 of CARO 2020:

a. whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;
b. whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;
c. whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;

**Question 11**

Discuss the reporting requirements as per CARO, 2020, regarding:

(i) Statutory Dues and (ii) Transactions with Related Parties [RTP Sep'24]

OR

M/s. PQ Limited has a turnover of ₹ 807 crores during the financial year 2023-24. It has outstanding dues towards Goods and Services Tax (GST) of ₹ 10 lakhs since June 2023. When enquired by the auditor, the company's management informed him that they have filed an objection letter for the said demand with the GST Authorities, however, no response is received from the GST Department. State the reporting responsibility of the auditor under paragraph 3, clause (vii) of the Companies Auditor's Report Order, 2020 [CARO, 2020].

**Solution**

Reporting under CARO,2020 regarding statutory Dues [Para 3(vii)]

(a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

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(b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

(ii) Reporting under CARO,2020 regarding transactions with related parties [Para 3(xiii)]

Whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards.

**Question 12**

ABC Ltd. is a public company, which has availed various loans and cash credit facilities from Banks and other financial institutions. The company has defaulted in repayments of such borrowings during the year under audit. What are the reporting requirements in this regard under the Companies (Auditor's Report) Order, 2020? [May'23]

**Solution**

As per Clause (ix) of CARO, 2020, reporting requirements in case of default by the company in repayments of borrowings would be:





a. Whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

| Nature of borrowing, including debt securities | Name of lender* | Amount not paid on due date | Whether principal or interest | No. of days delay or unpaid | Remarks, if any |
|---|---|---|---|---|---|
| | | | | | |

*Lender-wise details to be provided in case of defaults to banks, financial institutions and Government.

b. Whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

c. Whether term loans were applied for the purpose for which the loans were obtained ; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

d. Whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

**Question 13**

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements. Is there any reporting obligation upon him under CARO,2020? [MTP II May'24]

**Solution**

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

Facts of Case

In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹ 1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Conclusion

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

## Company Audit



**Question 1**

Section 143(1) of Companies Act, 2013 states that every auditor of a company shall have access to books of accounts and vouchers of company and shall be entitled to require from officers of company such information and explanation as considered necessary and shall inquire into certain matters. State those matters to be inquired. [MTP II Sep'24]

**Solution**

Under section 143(1) of the Companies Act, 2013 auditor shall inquire into following matters given as under: -

a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members
b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company
c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company
d) whether loans and advances made by the company have been shown as deposits
e) whether personal expenses have been charged to revenue account
f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

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**Question 2**

As per Rule 11(g) of the Companies (Audit and Auditors) Rules, 2014 auditor's report should state whether the accounting software used for maintaining its books of account has a feature of recording audit trail (edit log) facility. What are the reporting requirements under Rule 11(g)? [Nov'23]

**Solution**

The auditor's report shall report on following matters in accordance with Rule 11(g) of Companies (Audit and Auditors Rules), 2014):

Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and

1. the same has been operated throughout the year for all transactions recorded in the software and
2. the audit trail feature has not been tampered with and
3. the audit trail has been preserved by the company as per the statutory requirements for record retention.





## Test Your Understanding



**Question 1**

The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

**Solution**

Section 29(1) & (2) of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks.

- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
- Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

**Question 2**

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

**Solution**

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business.

Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

**Question 3**

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

**Solution**

Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.

It means there are overdues in accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

**Question 4**

CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

| | ₹ |
|---|---|
| Value of stocks | 125 lacs |
| Value of stock (fully damaged) included in above | 5 |
| Value of debtors | 50 lacs |
| Value of debtors exceeding 90 days included in above | 10 lacs |
| Value of creditors for goods | 50 lacs |

Is Drawing Power computed by CA P for ₹ 82.50 lacs proper?

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**Solution**

The computation of Drawing power is as under: -

| | |
|---|---|
| Value of stocks as on 31.12.22 | ₹ 125 lacs |
| Less: value of damaged stocks | ₹ 5 lacs |
| | ₹ 120 lacs |
| Less: creditors for goods as on 31.12.22 | ₹ 50 lacs |
| Value of Paid stocks | ₹ 70.00 lacs |
| Less: Margin @ 25% | ₹17.50 lacs |
| Drawing power (A) | ₹ 52.50 lacs |
| Value of debtors as on 31.12.22 | ₹ 50 lacs |
| Less: debtors exceeding 90 days | ₹ 10 lacs |
| | ₹40 lacs |
| Less: Margin @ 40% | ₹ 16 lacs |
| Drawing Power (B) | ₹ 24 lacs |
| **Drawing Power (A+B)** | **₹ 76.50 lacs** |

The drawing power calculated by CA P is **not proper**. Drawing Power comes to ₹ 76.50 lacs.





**Question 5**

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch. CA M is conducting statutory audit of branch of MMC Bank.

**Solution**

1. The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
2. The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

**Case Study**

During the course of audit, it is noticed as under:-

i) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops. In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".

ii) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "Manual of Delegation of Powers" of Bank.

iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.

iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.

v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

Based on above, answer following questions:

**(1) As regards description of agricultural advance, which of the following statements is most appropriate in this regard?**

a. The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.
b. The classification made by branch is proper. However, there are no transactions in account since last 30 days, it is Sticit.
c. The classification made by branch is proper.
d. The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.

(2) Regarding taken over account from another bank, which of following statements is most appropriate?
a. It is an internal issue of Bank and auditor is not concerned with it.
b. It is an internal issue of Bank. However, the auditor may, at his discretion, report it.
c. It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.
d. There is no issue involved as credit facility was properly sanctioned.

(3) As regards debit balance of ₹ 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?
a. The situation do's not attract RBI norms on asset classification.
b. The debit balance of ₹1.50 lacs should be classified as NPA.
c. It is to be seen if interest and other charges pass entries on credit facility was granted.
d. The bank cannot demand excess interest paid to account holder.

(4) Which of the following statements is not true about "drawing power" (DP)?
a. Drawing Power refers to the amount calculated based on primary security less margin as on particular date.
b. It is always less than sanctioned limit.
c. It can be different from sanctioned limit.
d. Creditors for goods are reduced for purpose of calculating Drawing Power.

(5) Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?
a. Both Housing loan as well as car loan should be classified as "NonPerforming Assets" in accordance with RBI norms on asset classification.
b. Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.
c. Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.
d. Both Housing as well as car loans should be classified as Standard assets.

1. c 2. c 3. b 4. b 5. a



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(1) Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?
a. Discount on Bills
b. Loan Processing fees
c. Commission on bills for collection
d. Credit Card Fees

(2) While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?
a. Appropriate documentation of advances
b. Ensuring budgeted targets of advances given by bank management
c. Compliance of sanctioned terms and conditions
d. Operations in advance accounts

(3) Any amount due to the bank under any credit facility is 'overdue' if: -
a. it is not paid on the due date fixed by the bank
b. it is not paid within 30 days of due date fixed by the bank
c. it is not paid within 60 days of due date fixed by the bank
d. it is not paid within 90 days of due date fixed by the bank

(4) Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?
a. The appointment is made by bank acting through its board of directors with prior approval of Central govt.
b. The appointment is made by bank acting through its board of directors with prior approval of RBI
c. The appointment is made by bank acting through its board of directors with prior approval of ICAI
d. The appointment is made by shareholders in AGM.

(5) Identify the correct statement: -
a. Income from non-performing assets is recognized on accrual basis
b. Income from non-performing assets is never recognized.
c. Income from non-performing assets is recognized on basis of actual recovery
d. Income from non-performing assets is recognized only when such assets are upgraded to standard assets

Solution 1. a 2. b 3. a 4. b 5. c

## Correct/Incorrect

(1) RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.

Incorrect. RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks.

(2) In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines that have bearing on the classification/ provisions and income recognition.

Incorrect. In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

(3) The auditor can assume that the system generated information is correct and relied upon.

Incorrect. The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

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(4) Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.

Incorrect. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

(5) Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof

Incorrect. Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(6) Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.

Incorrect. Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.





(7) An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Correct. An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

(8) Banks recognize income on Non-Performing Assets on accrual basis.

Incorrect: Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.

(9) Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.

Incorrect- Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

(10) Reporting of fraud of INR 150 Lakhs by auditor will be done within three days of the fraud coming to the knowledge of the auditor to the Board or the Audit Committee along with remedial action taken in case of audit of ABA Bank Ltd.

Incorrect- The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days. The Banking Company is bound to disclose remedial action taken in Board's report.

(11) Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets.

Correct: Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

There are different types of banks prevailing in India. Explain giving examples of such banks. [MTP Mar-21]

**Solution**

There are different types of banking institutions prevailing in India which are as follows:

1. Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy.

Two of its main functions are:-
(a) accepting deposits and (b) granting advances.

2. Regional Rural Banks known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. Examples are :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. Co-operative Banks function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. Examples are :- The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.

4. Payments Banks are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards.
However , customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobilebanking. Examples are :- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

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5. Development Banks had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country.
Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

6. Small Finance Banks have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc.
Examples are:- Equitas Small Finance Bank , AU Small Finance Bank , etc.

**Question 2**

In the case of a nationalised bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank. Explain what would the auditor state in his report. [MTP Oct-18]

**Solution**

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

a. whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank,





and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

b. whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

c. whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

d. whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

e. any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

**Question 3**

"If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smells any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".
Analyse and explain the above RBI Circular regarding liability of accounting and auditing profession.
[MTP Aug-18]

**Solution**

The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

"If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.

Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts.

SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable

assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Duty to report on Frauds under the Companies Act, 2013 - As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

**Question 4**

Mr. Piyush, the Bank Manager develops controls to aid in managing key business and financial risks. Discuss the various requirements for an effective risk management system in a bank. [May-19]

**Solution**

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An effective risk management system in a bank generally requires the following:

(i) Oversight and involvement in the control process by those charged with governance: Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

(ii) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(iii) Control activities: A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.

(iv) Monitoring activities: Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

(v) Reliable information systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged





with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

**Question 5**

The engagement team discussion ordinarily includes a discussion of the matters such as - Errors that may be more likely to occur; Errors which have been identified in prior years; Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures; etc. In the above context, explain the advantages of such a discussion. [RTP Nov-21 + July-21]

**Solution**

Advantages of such a discussion :-

- ✓ Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- ✓ It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- ✓ Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

**Question 6**

The discussion between members of the engagement team members and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. Briefly discuss the points ordinarily included in discussion of the engagement team. [Nov-19]

**Solution**

The engagement team discussion ordinarily includes a discussion of the following matters:

i) Errors that may be more likely to occur;
ii) Errors which have been identified in prior years;
iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and / or disclosure;
iv) Audit responses to engagement risk, pervasive risks and specific risks;
v) Need to maintain professional skepticism throughout the audit engagement,
vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g. the bank's application of accounting policies in the given facts and circumstances).

**Question 7**

Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report. [RTP May-21]

**Solution**

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

a. Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
b. Long Form Audit Report. (LFAR)
c. Report on compliance with SLR requirements.
d. Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
e. Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
f. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
g. Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Tilani Committee on internal control and inspection/credit system.
h. Report on instances of adverse credit-deposit ratio in the rural areas.

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**Question 8**

Explain the categories of Agricultural Advances in case of Banks and related NPA norms. (MTP Apr-22)

**Solution**

As per the guidelines, Agricultural Advances are of two types:
(1) Agricultural Advances for "long duration" crops; and
(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.
The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.





**Question 9**

"Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose."
Now he needs your assistance on the following points so as to incorporate them in the audit plan:
(i) for determination of NPA norms for agricultural advances
(ii) for accounts where there is erosion in the value of security/frauds committed by the borrowers.
[Nov-18]

**Solution**

(i) As dicussed in Answer 8

(ii) Accounts where there is erosion in the value of security / frauds committed by borrowers

Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.

i. Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

ii. If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

**Question 10**

After becoming Chartered Accountant, you have got your first assignment as an auditor of a bank branch dealing in various types of advances. What are the areas which you will be looking for obtaining sufficient appropriate evidence (for advances) besides studying and evaluating internal controls? [May-22]

**Solution**

Audit Procedure in Audit of Advances in case of Bank Audit: The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

i. examining the validity of the recorded amounts;
ii. examining loan documentation.
iii. reviewing the operation of the accounts;
iv. examining the existence, enforceability and valuation of the security;
v. checking compliance with RBI norms including appropriate classification and provisioning; and

vi. carrying out appropriate analytical procedures.

**Question 11**

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement. (MTP Apr-22)

**Solution**

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

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**Question 12**

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about amounts included in balance sheet in respect of advances which are outstanding. Explain stating clearly all the considerations in this context. [RTP Nov-22 + RTP May-21]





**Solution**

Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

a. Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
b. Advances represent amount due to the bank.
c. Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
d. There are no unrecorded advances.
e. The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
f. The advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements.
g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

**Question 13**

"There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank stating clearly the provision percent required. [MTP Oct-21 + Nov-22]

Solution

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Substandards assets, Doubtful assets and loss assets which are given below:

| Categories of NPA | Provision Required |
|---|---|
| Sub std assets<br>(NPAs upto 12 months) | 15% |
| Doubtful Assets<br>(Sub standard for period of 12 Months) | |
| Sub Categories<br>Doubtful upto 1 year | Secured/Unsecured<br>25%/100% |

| | |
|---|---|
| Doubtful 1-3 years | 40%/100% |
| Doubtful > 3 years | 100%/100% |
| Loss Assets:<br>Loss identified by bank/internal/external auditors or RBI but amt not written off wholly. | 100% |

**Question 14**

In case of a Bank, explain the meaning of Funded loans. Also give examples. [MTP Oct-21]

**Solution**

Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower.

Advances comprise of funded amounts by way of:

- Term loans :-
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

**Question 15**

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Distinguish between Primary Security and Collateral Security with reference to audit of Banks. Also give examples of most common types of securities accepted by the Banks. [RTP Nov-20]

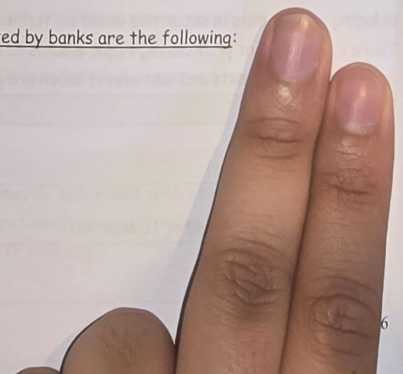
**Solution**

A. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies







**Question 16**

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks. [RTP Nov-20 + MTP Mar-23]

**Solution**

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

(i) Mortgage: Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
- Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) Pledge: A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) Hypothecation: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person.

- Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.
- An assignment gives the assignee absolute right over the moneys/debts assigned to him.

(v) Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor.

- The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).
- For the purpose of set-off, all the branches of a bank are treated as one single entity.
- The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien: Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

**Question 17**

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. [MTP Nov-21 + Jan-21]

**Solution**

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances.

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- ✓ Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.
- ✓ The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

**Question 18**

N Ltd. has been sanctioned a Cash Credit Facility by XYZ Bank Ltd. for INR 1 crore and drawing power as per the stock statements furnished for the last quarter is INR 80 Lakh. Outstanding balance in the account is INR 75 lakh. Interest charged to the account is INR 3.5 Lakh and total credit into the account for the quarter is INR 2.5 Lakh. As an auditor how will you report this account in your report. [July-21]

**Out of Order:** An account should be treated as 'out of order' if:

- the outstanding balance remains **continuously in excess of the sanctioned limit/drawing power** or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are **no credits continuously for 90 days** as on the date of Balance Sheet; or





- Credits are there but are **not enough to cover the interest debited during the same period**, these accounts should be treated as 'out of order'.

Applying the above to the given case of N Ltd, its Drawing power is ₹ 80 Lakhs, although outstanding balance in the account is ₹ 75 Lakhs, but still the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period.

**Question 19**

National Bank has advanced cash credit facility of ₹ 25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2023 to March 31, 2024: -

| Date | Particulars | Dr. | Cr. | Balance (Dr.) |
|---|---|---|---|---|
| 01.12.23 | To Transfer | 45,000 | | 24,75,000 |
| 31.12.23 | By Clearing | | 1,00,000 | |
| 31.12.23 | To Interest | 25,000 | | |
| 31.01.24 | To Interest | 24,700 | | |
| 29.02.24 | To Interest | 24,800 | | |
| 31.03.24 | To Inspection charges | 1,000 | | |
| 31.03.24 | To Interest | 24,900 | | |

Drawing power during the above period was consistent at ₹ 25 Lakh. The account was classified as "Standard asset" as on 31.12.2023 in books of Bank. The security charged with the bank remains intact throughout this period. Comment on "asset classification" of above account as on 31st March 2024 in books of Bank in accordance with RBI norms. [MTP Sep'24] **OR**

K Ltd. is availing cash credit limit of ₹ 25 crores from LMN Bank Ltd. The drawing power of the company range between ₹ 22 crores and ₹ 25 crores during the year 2023-24. The limit availed by the company remained less than ₹ 20 crores during all the days of the financial year 2023-24. The company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters. How will this account be classified in the books of LMN Bank Ltd. as on 31-03-2024? Explain. [Sep'24]

**Solution:**

In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or

- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ₹ 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet.

Therefore, it has become out of order and is required to be classified as NPA. Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.

**Question 20**

In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain. [RTP May-20]

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**Solution**

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.





**Question 21**

In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit. (i) Bank's Duties (ii) Auditor's concern (iii) Computation of DP (iv) Stock audit [MTP Apr-23]

**Solution**

Computation of Drawing Power:

(i) Bank's Duties:

- ✓ Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets.
- ✓ Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
- ✓ The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

(ii) Auditor's Concern:

- ✓ The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
- ✓ The audited Annual Report submitted by the borrower should be scrutinized properly.
- ✓ The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

(iii) Computation of DP: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

(iv) Stock Audit:

- ✓ The stock audit should be carried out by the bank for all accounts having funded exposure of more than 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same.
- ✓ Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital.
- ✓ The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

**Question 22**

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense. [RTP Nov-21]

**Solution**

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.

The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

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The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

The auditor should, on a test check basis, verify the calculation of interest and ensure that:

a. Interest has been provided on all deposits upto the date of the balance sheet;
b. Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
c. Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.
d. Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly.





The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers.

The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

**Question 23**

Explain the following in the context of Bank audit:

a. For audit of operating expenses, the auditor should study and evaluate the system of internal control relating to expenses.
b. For audit of Provisions and contingencies, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. [RTP May-22 + MTP Mar-23]

**OR**

You are the auditor of Plus Bank Limited. The bank has made following provisions for the year ended on 31.03.2024:

| Particulars | Amount (₹ in crores) |
|---|---|
| Provision for Bad Debts | 66 |
| Provision for Sub-standard Assets | 78 |
| Provision for Expenses | 24 |
| Provision for Income Tax | 55 |

You are in the process of verifying the provisions and contingencies of the bank. What audit approach and procedures will you adopt to verify the above? [Sep'24]

**Solution**

(a) For audit of operating expenses,

- Auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- The auditor should examine whether there are any divergent trends in respect of major items of expenses.
- The auditor should perform substantive analytical procedures in respect of these expenses. e.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
- The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

(b) For audit of Provisions and contingencies,

- the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets.
  - ✓ It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
  - ✓ The auditor may verify the loan classification on a sample basis.
  - ✓ The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- The other provisions for expenses should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

**Question 24**

When are following considered as non performing as per the RBI guidelines?
(i) Government guaranteed advances (ii) Advances to staff [MTP Mar-23]

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**Solution**

Government Guaranteed advances:

- Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

Advances to Staff

- Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank.
- In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.
- Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates.
- The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.





**Question 25**

CA X is acting as concurrent auditor of a branch of KLT Bank (a nationalized bank) located in Delhi during the year 2022-23. The assignment started from 1st October 2022 and is for a period of one year. By virtue of this assignment, he is required to issue monthly reports on different aspects of the functioning of branch including deposits, advances and housekeeping to controlling authorities of Bank. At the end of March, 2023, he has got an offer to conduct statutory audit of two branches of KLT Bank located in the State of Rajasthan for the year 2022-23. Can he accept the above offer? Discuss. [MTP Nov-23]

**Solution**

In the given situation, CA X has undertaken concurrent audit assignment of KLT Bank which is in the nature of internal assignments. In accordance with RBI guidelines, statutory audit assignments should not be undertaken by auditors while being associated with internal assignments in bank during the same year like concurrent audits (Internal audits of banks conducted monthly during the year).

As CA X is associated with KLT Bank as concurrent auditor, he should not accept statutory audit assignment of same bank even though it relates to different branches of the bank.

**Question 26**

While conducting statutory audit of branch of a nationalized bank, it is noticed by CA Z that credit facilities granted to a borrower consisting solely of term loan have been classified as "Sub-standard Asset" during the year 2022-23 due to failure of borrower to pay EMIs on time. Such EMIs were outstanding for more than 90 days and account was, therefore, classified as "Sub-Standard Asset". CA Z has also agreed to above asset classification made by branch management.

What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities? [RTP May'24]

**Solution**

RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.

Further, in respect of NPAs, fees, commission and other similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

In the given case, account has turned Sub-standard asset which is a type of NPA. Therefore, auditor should make compliance of above norms relating to income recognition.

**Question 27**

While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category. The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹7.50 lakhs. Is provision made by branch proper? Discuss. [MTP Nov-23]

**Solution**

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion.

Therefore, provision in above case is arrived as under: -

| | |
|---|---|
| Outstanding balance as on 31.3.23 | ₹ 50 lakhs |
| Less: Value of security | ₹ 40 lakhs |
| Unsecured portion | ₹ 10 lakhs |

Therefore, outstanding balance of ₹50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured.

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**Provision calculation**

| | |
|---|---|
| 25% of secured part i.e., 25% of ₹40 lakhs | ₹ 10 lakhs |
| 100% of unsecured part i.e.,100% of ₹10 lakhs | ₹ 10 lakhs |
| Required provision | ₹ 20 lakhs |

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹ 7.50 lakhs.

**Question 28**

Column A describes description of certain terms used in banking industry. Complete Column B by suggesting term appropriate to description given.

| A | B |
|---|---|
| 1. Audit of borrower client of bank carried out at bank's request to verify borrower's current assets | ? |
| 2. Limit up to which an entity can withdraw from sanctioned working capital limit | ? |
| 3. Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor | ? |
| 4. Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds | ? |

(MTP May'24)





**Solution**

1. Stock audit 2. Drawing power 3. Set-off 4. Equitable Mortgage

**Question 29**

During the course of statutory branch audit of a nationalized bank, CA Amrish is performing audit procedures in relation to the advances. He has verified the selected sample of borrower accounts representing advances and found nothing unusual. In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. List out few such documentary evidence which can be made use of by CA Amrish. [MTP II Sep'24]

**Solution**

In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. CA Amrish, the auditor should take into account the adverse comments, if any, on advances appearing in the following:-

- Previous year's audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection report.
- Concurrent / Internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

**Question 30**

Mahavir and Associates is appointed as the statutory auditor of KBC Bank for the financial year 2023-2024. During the audit, Ms. Chandana, an article trainee, noticed that Sidharth Industries had an outstanding loan of ₹ 50,00,000 as on March 31, 2024. On March 29, 2024, the company made a payment of ₹ 10,00,000, reducing the outstanding loan balance to ₹ 40,00,000. However, on April 4, 2024, Sidharth Industries initiated a reversal transaction of ₹ 8,00,000, increasing the outstanding loan balance back to ₹ 48,00,000. The payment and subsequent reversal occurred within a short period, with the final outstanding balance remaining ₹ 48,00,000 after the reversal.

Considering this scenario, what should be the response of Mahavir and Associates to this matter, particularly regarding the classification of the borrower's account and the potential risk of it slipping into the NPA category? [MTP I Jan'25]

**Solution**

Accounts regularized near the Balance Sheet Date: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity.

Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.

The auditor should check for sample transactions immediately before the closing of the financial year and immediately after the closing of the financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

Facts of Case

In the given case of Sidharth Industries, a payment of ₹10,00,000 was made on March 29, 2024 reducing the outstanding loan balance to ₹40,00,000. and subsequently reversed by ₹8,00,000 on April 4, 2024.

Conclusion

Thus, Mahavir and Associates should carefully assess the classification of Sidharth Industries' Account, and determine if the payment and reversal transactions indicate an attempt to prevent the account from slipping into the NPA category. If yes, the account should be classified as an NPA in compliance with regulatory guidelines.

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**Question 31**

Compute the Drawing Power for Cash Credit A/c of Kirpa Limited for the month of March 2024 with following information: (Amount in ₹)

| | |
|---|---|
| Stock | 60,000 |
| Debtors (Including Debtor of ₹ 15,000 for an invoice dated 20.10.2023) | 55,000 |
| Sundry creditors | 10,000 |
| Sanctioned Limit | 48,000 |

Margin on stock is 30% and on debtors is 40%.

Note: Debtors older than 3 months are ineligible for calculation of DP

[RTP Sep'24]

**Solution**

| Particulars of current assets | Amount (₹) | DP Amt |
|---|---|---|
| (A) Stocks | 60,000 | |
| Less: Sundry creditors | (10,000) | |
| Paid stocks | 50,000 | |
| Less: Margin 30% | (15,000) | 35,000 |
| (B) Debtors | 55,000 | |
| Less: Ineligible debtors | 40,000 | |
| Eligible debtors | (16,000) | |
| Less: Margin 40% | | 24,000 |
| Total Drawing Power | | 59,000 |





The sanctioned limit given in the question is ₹ 48,000 whereas drawing power as per the above working is ₹ 59,000. So, drawing power would be restricted to sanctioned limit i.e., ₹ 48,000/-.

**Question 32**

Agrim, a CA student, is part of an engagement team conducting audit of Madurai branch of ARB Bank. CA Bhuvan, engagement partner, has asked him to verify provision made by branch as on March 31st, 2024 in respect of the following non-performing assets: -

| Name of Account | NPA classification | Outstanding amount as on March 31st, 2024 (In ₹ lakhs) | Provision made (In ₹ lakhs) |
|---|---|---|---|
| AK Industries | Doubtful (D1) | 10.00 | 5.00 |
| Jupiter Traders | Substandard asset | 50.00 | 7.50 |
| VT & Co | Doubtful (D2) | 30.00 | 30.00 |
| ASD & Sons | Loss | 1.00 | 1.00 |

The engagement partner has already verified NPA classification. Outstanding amounts as on March 31st, 2024, relating to each NPA account listed above (except ASD & Sons) are fully secured. However, only personal guarantee of proprietor (Net worth of proprietor ₹50 lakhs) is available in account of ASD & Sons. Comment on the correctness of the above provisions.

Agrim is in dilemma regarding classification of above accounts as NPA although these are fully secured or guaranteed. Guide him. (RTP Jan'25)

**Solution**

The auditor is required to ensure that provision for NPA is made as per its classification in different categories which are given as under:

| Categories of Non-Performing Assets: | Provision required |
|---|---|
| Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months. | 15% |
| Doubtful Assets: Would be one which has remained in the substandard category for a period of 12 months. | |
| Sub-categories: | (Secured + Unsecured) |

| | |
|---|---|
| Doubtful up to 1 Year (D1) | 25% + 100% |
| Doubtful 1 to 3 Years (D2) | 40% + 100% |
| Doubtful more than 3 Years (D3) | 100% + 100% |
| Loss Assets | 100% |

From the above provision, it can be concluded that in case of:

| | |
|---|---|
| AK Industries | It has been classified as Doubtful (D1) category. Therefore, it requires provision of 25% of secured amount. That is provision of Rs 2,50 lakh (i.e 25% of ₹10 lakh) should be made instead of ₹ 5 lakh. |
| Jupiter Traders | It has been classified as Substandard asset. It requires provision of 15% of outstanding amount (i.e 15% of ₹ 50 lakhs) which comes to ₹ 7,50 lakh. Therefore, provision made by the branch is correct. |
| VT & Co. | It has been classified as Doubtful (D2) category. It requires provision of 40% of secured amount. That is provision of ₹ 12,00 lakh (40% of ₹ 30 lakhs) should be made instead of ₹ 30 lakh. |
| ASD & Sons | It has been classified as a loss asset which requires provision of 100% of outstanding amount. Therefore, the provision made by the branch is correct. |

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Hence, these accounts have been classified as NPA on the record of recovery although these are fully secured or guaranteed.

CA Intermediate notes

**Question 33**

MNB bank advanced certain loans guaranteed by government. State the prudential norms for asset classification and income recognition of such loans. [May'24]

**Solution**

Government Guaranteed Advances (In case of accounts overdue for more than 90 days):

- Central Government Guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

"If you can THINK about it, you can ACHIEVE it"





Consider the following five descriptions:-

(A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website cag.gov.in.

"The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

(B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under:

"The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."

(C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

(D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

(E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India.

The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

Based on above, answer following questions:

(1) **Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.**

a. Audit against provision of funds
b. Propriety audit
c. Performance audit

d. Compliance audit

**(2) Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.**

a. Audit of Government Company
b. Audit against rules and orders
c. Compliance audit
d. Performance audit

**(3) Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?**

a. It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.
b. It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.
c. It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.
d. It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.

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**(4) Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?**

a. Central Government
b. Another independent auditor appointed by CAG
c. CAG
d. Another independent auditor appointed by Ministry of Corporate Affairs

**(5) As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?**

a. Such are likely to be comments of test audit carried out by CAG.
b. Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.
c. Such are likely to be comments of supplementary audit carried out by CAG
d. Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing

1. c 2. d 3. a 4. c 5. b





1. Consider following revenue sources of Union Government.
(P) Revenues from direct taxes
(Q) Revenues from Goods and Services Tax
(R) Revenues from Custom Duties
(S) Revenues from Excise Duties
Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?
a. P, Q and R
b. P, Q and S
c. P and Q
d. P, Q, R and S

Ans D

## Test Your Understanding

**Question**

It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?

**Solution**

Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

## Correct/Incorrect

1. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe. (SM)

Incorrect. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

2. According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

Correct. According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations i.e. the expenditure is incurred with due regard to broad and general principles of financial propriety

## Past Exams/RTPs/MTPs/SM Questions

**Question 1**

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit. [RTP May-21]

**Solution**

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

Classic Notes

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:-

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

**Objectives :-**

a. Accounting for Public Funds:- Government audit serves as a mechanism or process for public accounting of government funds.





b. Appraisal of Government programme and policy aspects of public administration as well as accountability of the officials administering them.

c. Base for Corrective actions:- Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

d. Administrative Accountability:- The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

**Question 2**

C&AG's (Duties, Powers and Conditions of Service) Act, 1971 provides certain powers to the C & AG in connection with performance of his duties. Discuss. [MTP Nov-21/Apr-23]

**Solution**

Powers of C & AG in performance of his duties: C&AG's (Duties, Powers and Condition of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

(i) To inspect any an office accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.

(ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(iii) To put such questions or make such observations as he may consider necessary to the person- in charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

**Question 3**

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards. [MTP Apr-22]

Expenditure Audit: The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

ii) that there is sanction, either special or general, accorded by competent authority authorizing the expenditure. Such an audit is called as the audit of sanctions.

iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.

iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

**Question 4**

Audit against propriety seeks to ensure that expenditure conforms to certain principles which have for long been recognised as standards of financial propriety. Explain those principles. [MTP II May'24]

OR

"Public moneys should not be utilised for the benefit of a particular person or section of the community". List out the exceptions to this rule while audit against propriety. [MTP Oct-21]

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**Solution**

Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

a. The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

b. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

c. Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

   i) the amount of expenditure involved is insignificant; or

   ii) a claim for the amount could be enforced in a Court of law; or

   iii) the expenditure is in pursuance of a recognised policy or custom; and

   iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.





**Question 5**

PQR Ltd., a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in the infructuous expenditure. Considering the above case, explain the type of expenditure audit to be performed to curb the situation. [MTP Nov-21]

**Solution**

Propriety audit: According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

Facts of Case

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Conclusion

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

**Question 6**

C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. Explain. [MTP Oct-20]

**Solution**

Compile and submit Accounts of Union and States - C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

C&AG shall, from accounts compiled by him or [by Government or any other person responsible in that behalf] prepare in each accounts (including, in case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of UT having a Legislative Assembly, as

the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to Union and States. C&AG shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

**Question 7**

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain.

[RTP Nov'20 +MTP Oct'21]

**Solution**

Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder.

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It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

is the function of the executive government to frame rules, regulations and orders, which are to be served by its subordinate authorities. The job of audit is to see that these rules, regulations and ders are applied properly by the subordinate authorities. It is, however, not the function of audit to scribe what such rules, regulations and orders shall be.







ation of the various rules, regulations and orders

But, it is the function of the executive authorities to see that:

a. they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

b. they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

c. they do not come in conflict with the orders of, or rules made by, any higher authority; and

d. in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

**Question 8**

The auditor of a Govt Company has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. Explain [RTP Nov-20]

**Solution**

Audit of sanctions - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.

The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

**Question 9**

The audit of receipts of government is not as old as audit of expenditure but with the rapid growth of public enterprises audit of receipts tax or non-tax has come to stay. Discuss audit of receipts with respect to Government Audit. [Nov-20]

**Solution**

Government auditing in India as elsewhere was primarily expenditure- oriented. Gradually, audit of receipts-tax and non-tax was taken up.

The audit of receipts is neither all pervasive nor as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

iii) whether such regulations and procedures are actually being carried out;

iv) whether adequate checks are imposed to ensure prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds; and

v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. Are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review ,in-depth study of specified areas, etc ,as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.

vii) Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built -in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.

viii) The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

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**Question 10**

*Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. Explain [RTP May-21]*

**Solution**

- ✓ Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.
- ✓ The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.
- ✓ In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department.





- ✓ Audit is a necessary ... of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability.
- ✓ The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

**Question 11**

*In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG. [Nov'21]*

**Solution**

Audit of Accounts of Stores and Inventories in Government Companies: Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:-

i) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.

ii) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

iii) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

iv) to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

v) to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding.

Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

**Question 12**

*Goods and Services Tax Network (GSTN) is a not for profit, limited by shares, company. Its 50% shareholding is with Union Government and 50% with different State Governments. The company*

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provides IT infrastructure and services to various stakeholders including governments and tax payers. The company is in operation since past few years and subsequent auditor needs to be appointed during financial year 2023-24. Who appoints statutory auditor of such a company described above in accordance with provisions of Companies Act, 2013? Can any directions be issued to statutory auditors of above company? [MTP May'24]

**Solution**

The above company is a government company.

Section 143(5) of the Companies Act,2013 states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) of section 139 i.e. appointment of subsequent auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statements of the company.

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**Question 13**

SK & Co, a Chartered Accountant firm has been appointed an auditor of Metro Rail project in City A. Since the project is on large scale, it involves a high volume of resources (financial, human and physical resources). The appointing authority C&AG requires an objective examination of the financial and operational performance of the Metro Rail project.

Explain the nature and scope of audit that SK & Co will undertake. [May'23]

**Solution**

Performance audit - The scope of the audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit.

Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether the government has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

**Question 1**

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

**Solution**

The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members.

As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to: -

a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place
b. the assets and liabilities

**MCQ**

**The appointment of first auditor of a multi-state cooperative society is made by: -**

(a) Central Registrar
**(b) Board of society**
(c) Members of society
(d) Central Government

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Past Exams/RTPs/MTPs/SM Questions

**Question 1**

You are appointed as an auditor of co-operative society. State the special features of the co-operative audit to be borne in mind by the auditor, concerning:

(1) Audit classification of society. (2) Discussion of draft audit report with the management committee. [Nov-20]

**Solution**

(1) Audit classification of society - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(2) Discussion of draft audit report with managing committee - On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit





draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

**Question 2**

Section 77 of Multi-State Cooperative Societies Act, 2002 states that the Central Government may at any time by order direct that a special audit of the Multi-State Co-Operative Society's accounts for such period or periods as may be specified in the order, shall be conducted. Further, it may by the same or a different order appoint either a Chartered Accountant or the Multi-State Co-Operative Society's auditor himself to conduct special audit. Under which circumstances such power can be exercised by the Central Government? [RTP Sep'24]

**OR**

Central Govt. hold 55% of the paid up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act. [May-19 + MTP Apr-23]

**Solution**

Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi -State co-operative society.

Under section 77 of the Multi-State Co- operative Societies Act, 2002, where the Central Government is of the opinion:

i) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
ii) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
iii) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

**Question 3**

Briefly explain the provisions for qualification and appointment of Auditors under the Multi- State Co-operative Societies Act, 2002. [Nov-18 + MTP Apr-21] **OR**

Section 72(1) of the Multi-State Co-operative Societies Act, 2002 states that only a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can be appointed as

an auditor of a multi-state co-operative society. Who, according to Section 72(2), is disqualified fro being appointed as auditors of a multi-state co-operative society? [MTP I Sep'24]

**Solution**

Qualification of Auditors - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However, the following persons are not eligible for appointment as auditors of a Multi-State co-operative society-

a. A body corporate.
b. An officer or employee of the Multi-State co-operative society.
c. A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
d. A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

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Appointment of Auditors - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi- State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

**Question 4**

As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain [RTP May-20]





**Solution**

As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co- operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

a. In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
b. In the case of the profit and loss account, of the profit or loss for its financial year.

The auditor's report shall also state:

i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

**Question 5**

Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002. [RTP May-20

**Solution**

Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi- State co-operative society or elsewhere, and shall be entitled require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor

As per section 73(2), the auditor shall make following inquiries:

a. Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,
b. Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
c. Whether personal expenses have been charged to revenue account, and
d. Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

**Question 6**

No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section. [RTP May-22]

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**Solution**

Inspection of Multi-State Co-operative societies under Section 79

1. When: The Central Registrar may, on a request from
   i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or
   ii) not less than one-third of the members of the board or
   iii) not less than one-fifth of the total number of members of a Multi-State co-operative society

2. How: By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.

3. Opportunity of Being heard: No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

4. Powers available: The Central Registrar or the person authorized by him shall have the following powers:
   a. He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society





and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
   b. Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

5. Inspection Report: A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

**Question 7**

CA, Z, a Chartered Accountant is the Senior manager of a Multi-State Co-operative Society in Mumbai. He is proposed to be appointed as an auditor of the said Multi -State Cooperative Society. Analyse the provisions of the Multi-State Co-operative Societies Act, 2002 and comment on validity of proposed appointment. [May'23]

**Solution**

Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

Considering the facts given in the question, the following persons are not eligible for appointment as auditors of a Multi-State co-operative society-

a. An officer or employee of the Multi-State co-operative society.
b. A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.

In view of above, CA, Z being officer of Multi State Co-operative Society is not eligible for appointment as Auditor and therefore proposed appointment of CA Z is not valid .

**Question 8**

You have been appointed as an auditor of Co-operative society. During the course of audit, you have noticed some serious irregularities in the working of the society. Enumerate those special matters for reporting to the Registrar. [Sep'24]

**Solution**

Special report to the Registrar: During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar,

drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society.

In the following cases, for instance, a special report may become necessary:

i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
iii) Specific examples of mis-management. Decisions of management against co-operative principles.
iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

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**Question 1**

Draft an Audit Programme for conducting Audit of Local Bodies. [MTP Nov-23]

**Audit Programme for Local Bodies**

(i) APPOINTMENT:-The Local Fund Audit Wing of the State Govt. is generally incharge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.

(ii) AUDITOR'S CONCERNS:-The auditor while auditing the local bodies should report on the

- fairness of the contents and presentation of financial statements,
- the strengths and weaknesses of system of financial control,
- the adherence to legal and/or administrative requirements;
- whether value is being fully received on money spent.

His objective should be to detect errors and fraud and misuse of resources.

(iii) RULES & REGULATIONS :- The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) AUTHORISATIONS :- He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) PROVISIONING :- He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) PERFORMANCE :- The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

**Question 2**

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Explain.

**Solution**

Financial Administration: It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit.

Some of the aspects are as under:

(a) Budgetary Procedure: This is geared to subserve the twin considerations of financial accountability and control of expenditure. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure. Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of the capital transactions. There are, however, a number of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

(b) Expenditure Control: The system of financial control existing in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive. The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well. Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

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(c) Accounting System: Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. Both these situations are not conducive to a proper system of management information.

**Question 3**

List out the types of Revenue Grants received by local bodies from the State. [MTP Nov-21 + Nov-20]

**Solution**

Local bodies may receive different types of grants from the state administration. Broadly the revenue grants are of three types:

1. General purpose grants: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
2. Specific purpose grants: These grants which are tied to the provision of certain services or performance of certain tasks.
3. Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.





**Question 4**

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. Explain stating important objectives of audit of such bodies. [RTP Nov-21]

OR

Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas? [Dec-21]

**Solution**

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

The important objectives of audit are:

a. reporting on the fairness of the content and presentation of financial statements;
b. reporting upon the strengths and weaknesses of systems of financial control;
c. reporting on the adherence to legal and/or administrative requirements;
d. reporting upon whether value is being fully received on money spent; and
e. detection and prevention of error, fraud and misuse of resources.

**Question 5**

CA Sevak is appointed as an auditor of a Municipal Corporation of a big smart city. He wants to verify various expenditures of the Municipality. Define the term "Municipality" and state what are the heads under which expenditures incurred by the Municipalities and Corporations can be broadly classified ? [Nov-22]

**Solution**

A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality - a village, a town, a city or any other area smaller than a state - by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

a. general administration and revenue collection,
b. public health,
c. public safety,
d. education,
e. public works, and

f. others such as interest payments.

## MCQs

**The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?**

(a) To report on the adherence to legal and administrative requirements
(b) To report on whether value is being fully received for money spent
(c) To report on the weakness of systems of financial control
**(d) To provide better civic amenities to residents of metro city**

## Audit of NGOs

### Question 1

As an Auditor of NGO, how do you check/verify atleast four receipts of income during the year? [Jan-21 + MTP Apr-23]

**Solution**

The receipt of income of NGO may be checked on the following lines:

i) Contributions and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

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ii) Receipts from fund raising programmes: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

iii) Membership Fees: Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

iv) Subscriptions: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/ circulars/periodicals. Check the receipts with subscription rate schedule.

v) Interest and Dividends: Check the interest and dividends received and receivable with investments held during the year.

### Question 2

While planning the audit of an NGO, the auditor may focus on Knowledge of the NGO's work, its mission and vision, Updating knowledge of relevant statutes especially with regard to recent amendments,





circulars etc. Explain the ... the auditor needs to focus while planning the audit of NGO. [Nov'23 + RTP Nov-21]

**Solution**

While planning the audit, the auditor may concentrate on the following:

i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
vii) Setting of materiality levels for audit purposes.
viii) The nature and timing of reports or other communications.
ix) The involvement of experts and their reports.
x) Review the previous year's Audit Report.

### Question 3

The audit programme of NGO should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted. Explain. [MTP Mar-21]

**Solution**

i) Corpus Fund: The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
ii) Reserves: Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
iii) Ear-marked Funds: Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
iv) Project / Agency Balances: Vouch disbursements and expenditure as per agreements with donors for each of the balances.
v) Loans: Vouch loans with loan agreements, counterfoil of receipt issued.

vi) Fixed Assets: Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.

vii) Investments: Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis - investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

viii) Cash in Hand: Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.

ix) Bank Balance: Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

x) Inventory: Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

xi) Programme and Project Expenses: Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

xii) Establishment Expenses: Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

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**Question 4**

"Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?

(a) Income Tax Act, 1961
**(b) Foreign Contribution Regulation Act, 2010**
(c) Companies Act, 2013
(d) Orders issued by Ministry of Social Justice and Empowerment

## Audit of Partnership Firm

**Question 1**

Discuss the matters which should be specially considered in the audit of accounts of a partnership. [RTP May-19]

**Solution**

Matters which should be specially considered in the audit of accounts of a partnership:





i) Letter of Appointment: ... the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

ii) Partnership Documents:- Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

iii) Objects of Partnership:- Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

iv) Books of Account:- Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

v) Mutual Interest:- Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

vi) Provision for Taxes:- Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

vii) Division of Profits:- Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

**Question 2**

State six important advantages of audit of accounts of a Partnership firm. [MTP Apr-19 + RTP Nov-23]

**Solution**

On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

1. Disputes:- Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.
2. Dissolution:- On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
3. Reliable:- Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.
4. Admission:- Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

5. Control:- An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

**Question 3**

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm. (SM)

**Solution**

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

## Audit of LLP

**Question 1**

Tomo Construction Engineering LLP approached CA K to understand various returns to be maintained and filed by them. Guide/Discuss the various returns to be maintained and filed by them. [July-21]

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**Solution**

Returns to be maintained and filed by an LLP:

- Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months or the financial year to which the Statement of Account and Solvency relates.

**Question 2**

Ban LLP is formed during the year 2021-22. They are not sure about 4 the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain? [Nov-22]

**Solution**

LLP's are required to maintain books of accounts which shall contain

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,





3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

**Question 3**

The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment. [SM]

**Solution**

Incorrect- The auditor is to be appointed by the designated partners of the LLP. However , the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

**Question 4**

An LLP files compliance returns with: -

(a) Registrar of firms & societies
(b) Central Registrar
(c) Registrar of Companies
(d) Local fund audit wing

**Ans (c)**

**Question 5**

While auditing the financial statements of Bro Traders LLP, CA L is carefully going through LLP agreement. Briefly discuss the key points CA L should pay attention in the LLP agreement and the reporting responsibilities of CA L concerning the financial statements of Bro Traders LLP? [MTP II Sep'24]

**Solution**

LLP Agreement:- The auditor should read the LLP agreement & note the following provisions

a) Nature of the business of the LLP.
b) Amount of capital contributed by each partner.
c) Interest – in respect of additional capital contributed.
d) Duration of partnership.
e) Drawings allowed to the partners.
f) Salaries, commission etc. payable to partners.
g) Borrowing powers of the LLP.
h) Rights & duties of partners.
i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
j) Any loans advanced by the partners.

k) Profit sharing ratio

Reporting :- The auditor should mention

a) Whether the records of the firm appear to be correct & reliable.
b) Whether he was able to obtain all information & explanation necessary for his work.
c) Whether any restriction was imposed upon him.

## Audit of Charitable Institutions

**Question 1**

CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution. [Dec-21]

**Solution**

Audit Procedure to be undertaken by CA A in respect of Subscriptions and donations received by a Charitable Institution is:

i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
ii) Whether official receipts are issued;
   a. confirming that adequate control is imposed over unused receipt books;
   b. obtaining all receipt books covering the period under review;
   c. test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;
   d. obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
   e. examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
   f. verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

**Question 2**

In the case of audit of a charitable institution, what attentions should be paid by the auditor regarding audit of expenditure items? [RTP Nov-20 + May-23]

**Solution**

Audit of Expenditure of Charitable Institution:

i) Vouching payment of grants also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution





has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.
ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.
iii) Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.
iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.
v) Verifying the cash and bank balances/payments.

## Audit of Educational Institutions (SCHOOL,COLLEGE OR UNIVERSITY)

**Question 1**

What are the special steps involved in conducting the audit of an Educational Institution? (Write any 12 points) [RTP Nov-19]

**Solution**

The Special Steps Involved in the Audit of an Educational Institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

Tuition Fees [MTP Mar-21]

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.





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(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

**Question 2**

You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools. [July-21]

**Solution**

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Verification of Assets & Liabilities of VJM Schools:

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.
3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the system of ordering & inspection on receipt and issue of provisions, food stuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
5. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

**Question 3**

You are auditor of a college running different courses operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same and also explain two other points to verify fees from students. [SM + MTP May'24]





**Solution**

Fee from Students:

The fees concessions have to be under proper authority of college management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

Other points to verify fee from students are :

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal control which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
5. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
6. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

**Question 4**

CA Z is appointed as the auditor of Chanakya Open University which offers higher learning educational courses through the Distance Mode of Education. Discuss four steps involved in his audit of other receipts/grants and donations received by the University. [Nov'23]

**Solution**

Audit of Other Receipts/Grants & Donations by CA Z would involve the following steps:

- Verify rental income from landed property with the rent rolls, etc.
- Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- Verify any Government or local authority grant with the memo of grant.
- If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

## Audit of Hospital



**Question 1**

M/s T & Co. Chartered Accountants, a partnership firm, is appointed as an auditor of Treatment Hospital run by Smile Foundation, a charitable trust. Over and above the receipts of treatment of patients, during the year trust has received donations from various donors to treat COVID-19 patients and also incurred some capital expenditure for further development of the hospital. On some of the investment income, income tax has been deducted. What are the special points to be considered by M/s T & Co. while auditing such transactions of Treatment Hospital? [May-22]

**Solution**

Audit of a Hospital:

(A) Receipts from treatment of patients

1. Register of Patients: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. Collection of Cash from patients: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

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(B) Donations: Verify that the legacies and donation received for a specific purpose have been applies in the manner agreed upon.

(C) Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

(D) Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

(i) vouching the Income-tax refund with the correspondence with the Income-tax Department; and
(ii) checking the calculation of the repayment of claims/refund claim.

**Question 2**

You have been appointed auditor of M/s. BLK Hospital. Discuss important points that would attract your attention while audit. [MTP Apr-22]

**Solution**

The important points involved in such an audit are stated below:

i) Register of patients: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients attendance record to see that the bills have been correctly





prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

ii) Collection of Cash: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of tickets, etc. other evidence.

iii) Income from Investments, Rent etc.: See by reference to the property and investment ledgers that all income that should have been received by way of rent or property, dividends etc. on securities have been collected.

iv) Legacies and Donations: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

v) Reconciliation of Subscriptions: Trace all collections of subscriptions and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

vi) Authorisation and sanctions: Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.

vii) Grants and TDS: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

viii) Budgets: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

ix) Internal Check: Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

x) Depreciation: See that depreciation has been written off against all the assets at the appropriate rates.

xi) Registers: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

xii) Inventories: Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.

xiii) Management Representation and Certificate: Get proper Management Representation and Certificate with respect to various aspects covered during audit.

## Audit of Club

**Question 1**

You are appointed as an auditor of "The Prestigious Township Club". As the auditor of "The Prestigious Township Club" for the financial year 2023-24, what are the key points you would consider while auditing the income and expenditure items of the club? [MTP Jan'25 + Jan'21]

**Solution**

The special steps involved, to be considered by the Internal Auditor of City Club in conducting the audit of receipts of the club are stated below-

a. Entrance Fee: Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
b. Subscriptions: Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
c. Arrears of Subscriptions: Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
d. Arithmetical accuracy: Check totals of various columns of the Register of members and tally them across.
e. Irrecoverable Member Dues: See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
f. Pricing: Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
g. Member Accounts: Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
h. Purchases: Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
i. Margins earned: Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
j. Management Powers: Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

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## Audit of Cinema

**Question 1**

Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets? [MTP May'24 + RTP Nov-22 + Nov-22]

**Solution**

The special steps involved in the audit of receipts from sale of tickets are stated below-

i) Verify that entrance to the cinema-hall during show is only through printed tickets;
ii) Verify that they are serially numbered and bound into books
iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially
iv) Verify that for advance booking a separate series of tickets is issued;
v) Verify that the inventory of tickets is kept in the custody of a responsible official.
vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
vii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.
ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

## Audit of Hire Purchase & Leasing Companies

**Question 1**

Define the different types of lease agreements as per Accounting Standard/Ind-AS. [May-19]

**Solution**

AS-19/ Ind-AS 17 defines that lease arrangements could be of 2 types i.e.
(i) Finance Lease and
(ii) Operating Lease.

Finance Lease:

An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- Lessee has option to purchase asset at a price that is expected to be sufficiently lower than fair value at the date option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialized nature that only the lessee can use them without major modifications Operating Lease.

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

**Question 2**

An Operating Lease is a kind of Financing arrangement. [SM]

Incorrect- A Finance Lease is a Financing arrangement. An Operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

**Question 3**

P Financial Services Ltd. (PFSL) is a leasing & hire purchase company. You, as an auditor of PFSL, are in the process of examining finance lease agreements executed by them for equipment given on lease. Which points shall be noted by you while examining a particular finance lease agreement entered into by PFSL in respect of a leasing transaction? [Sep'24]

OR

ABC Ltd. wants to buy some equipment on lease and hence is required to sign lease agreement with the supplier of the equipment. What are the important points to be considered in the lease agreement? [SM]

**Solution**

The important points to be examined in the lease agreement are:

i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

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**Question 4**

From a lessee's perspective, highlight main differences between an operating lease and finance lease only in relation to accounting treatment and tax benefits. [RTP May'24]

**Solution**

Accounting treatment

Operating lease is generally treated like a renting arrangement. Lease payments are treated as operating expenses and asset does not appear as asset in lessee's balance sheet.

Finance lease is treated like a loan arrangement. Hence, asset ownership is considered of that of lessee and thus appears on the balance sheet of the lessee.

Tax benefits

Operating lease payment is considered like an expense just as in case of renting. However, no depreciation can be claimed by lessee. In case of finance lease, lessee can claim both interest and depreciation as it is treated like a loan.

**Question 5**

JK Ltd. has opened a new manufacturing unit and for that they want plant & machinery. Since the capital outflow will be huge, they are considering of taking it on lease. They have approached several parties and have shortlisted one of them who is ready to give the plant on lease for 11 years, which is approximately the estimated economic life of the asset. As per the agreement, JK Ltd. will bear the insurance and maintenance expenses of the asset. Which kind of lease agreement have JK Ltd. entered into and what is the ownership status, the accounting treatment and the tax benefits of the same?

[May'24]

**Solution**

In the given situation, JK Ltd. has opened a new manufacturing unit and for that they want plant & machinery. They have taken the plant on lease for 11 years, which is approximately the estimated economic life of the asset. As per the agreement, JK Ltd. will bear the insurance and maintenance expenses of the asset. Same will be considered as Finance Lease as per AS-19 since the lease term is for a major part of the economic life of the asset even if title is not transferred.

- Status of Ownership: Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.
- Accounting treatment: Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
- Tax benefit: Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

## Audit of Hotels

**Question 1**

You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2024-25. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages? [MTP May'24 + RTP Nov-22]

**Solution**

Verification of inventories in the nature of food and beverages: Inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Therefore, following points may be noted in this regard:

a. All movement and transfer of inventories must be properly documented.
b. Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
c. The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
d. Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
e. The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

**Question 2**

Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain. [RTP May-22 + MTP Nov-23]

**Solution**

- Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined.
- It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated.
- The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.



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- The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.
- The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.
- If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts.
- As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

**Question 3**

An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel. [SM]

**Solution**

Correct- The auditor should ensure that proper valuation of occupancy-inprogress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintainance of accounts on Accrual basis as per the Matching concept.

**Question 4**

Explain and also state the role of auditor with respect to the following in case of a hotel:
Travel agents & shops [MTP Mar-23]

**Solution**

(i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
(ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

**Question 5**

As an auditor, explain the areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel. [MTP Apr-23]

**Solution**

Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel:-

1. The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.
2. The source of these entries is the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
3. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
4. In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
5. Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.
6. Special emphasis to be laid on receipts through Credit Cards.
7. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.



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## Test Your Understanding

**Question 1**

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

**Solution**

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company. This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

**Question 2**

A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

**Solution**

It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

**Question 3**

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

**Solution**

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

**Question 4**

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

**Solution**

Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

**Question 5**

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of depreciation by company proper in its books?

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**Solution**

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

## Case Study

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020-21.

The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.





The company raised fresh capital of ₹ 5 Cr during the FY 2022-23. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share. The company has the Reserves and Surplus totaling to ₹ 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount.

The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers. CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ₹ 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process.

The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- Current maturities to long term borrowings
- Long term maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings

Based on the above facts, answer the following questions:

**1. Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?**

a) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a securities premium account.

b) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.
c) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.
d) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.

**2. Which of the following is not an example of capital reserve?**
a) Revaluation reserve arising from revaluation of fixed assets
b) Securities Premium
c) Capital redemption reserve
d) General reserve

**3. Statement 1: Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.**
**Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances.**
a) Only statement 1 is correct
b) Only statement 2 is correct
c) Both statements 1 & 2 are correct
d) Both statements 1 & 2 are incorrect

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**4. Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?**
a) Consumption Analysis
b) Stock Composition Analysis
c) Reasonableness test
d) Ratio analysis

**5. Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2013?**
a) Current maturities of long term borrowings is to be disclosed under the head long term borrowings
b) Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings
c) Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities
d) Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

**1. c 2. d 3. c 4. b 5. a**





**1. An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?**
(a) Occurrence; Existence
(b) Occurrence; Completeness
(c) Existence; Occurrence
(d) Completeness; Occurrence

**2. Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?**
(a) No separate disclosure of goods in transit is required.
(b) Disclosure of total goods in transit under head of inventories is required.
(c) Disclosure of goods in transit under each sub-head of inventories is required.
(d) Disclosure of goods in transit for raw material and finished goods is required.

**3. Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:-**
(a) Directors only
(b) Clients only
(c) Directors or employees
(d) Auditors only

**4. Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?**
(a) Installation costs
(b) Freight cost of bringing the item to its location
(c) Inaugural costs
(d) Employee benefit cost for making such an item suitable for production

**5. Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"**
(a) Balance with Banks
(b) Balance with scheduled banks
(c) Cash on hand
(d) Cheques on hand

1. a 2. c 3. c 4. c 5. b

## Correct/Incorrect



State with reasons (in short) whether the following statement is correct or incorrect:

1. Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.

Incorrect: Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

2. Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.

Incorrect: Dividends are recognised in the statement of profit and loss only when:
i) the entity's right to receive payment of the dividend is established;
ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
iii) the amount of the dividend can be measured reliably

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3. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Incorrect: "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called

4. Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

Incorrect: Revenue reserves represent profits that are available for distribution to shareholders.

5. A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.

Correct: A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.







6. If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.

Incorrect: If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the periodend (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);

All buildings owned and controlled by Company X are included within the carrying amount of ₹ 100 lakh (Completeness assertion).

7. Material and wages are considered to be revenue expenditure when incurred for construction of building.

Incorrect: Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Plant, Property and Equitment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.

8. PPE are depreciated when the asset is actually put to active use.

Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criteria for charge of depreciation.

9. Increase in authorised capital of the company requires special resolution to be passed at the general meeting.

Incorrect: Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.

10. Capital redemption reserve can be used for distribution of dividends.

Incorrect: Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends. CRR can be used only for the purpose of issuing fully paid up bonus shares.

11. Dividends are recommended by the Board, and declared by the Shareholders.

Correct: The dividends are recommended by the Board of Directors by passing a resolution at the board meeting. The Shareholders declare the dividends at the AGM by passing an ordinary resolution. Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.

12. In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity.

Correct: While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due. The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

## SM Questions

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**Question 1**

How will you vouch and/or verify the following:

a. Goods sent out on Sale or Return Basis.
b. Borrowing from Banks.

(a) The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:

i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.





(b) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Question 2**

How will you vouch/verify the following:

(a) Goods sent on consignment.
(b) Foreign travel expenses.
(c) Receipt of capital subsidy.
(d) Provision for income tax.

(a) Goods Sent on Consignment:

i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

v) See that goods in hand with the consignee have been shown separately under the head inventories.

(b) Foreign Travel Expenses:

i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

ii) Verify that the tour programme was properly authorised by the competent authority.

iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Receipt of Capital Subsidy:

i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

iii) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

iv) Check relevant entries for receipt of subsidy.

v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

Provision for Income Tax:

i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.

iv) Compute tax payable as per the latest applicable rates in the Finance Act.
Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.



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vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

**Question 3**

Explain how you will verify the items given while conducting an audit of an entity :
(a) Payment of Taxes
(b) Sale proceeds of scrap material
(c) Advertisement Expenses.

Payment of Taxes:

i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.

ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

iv) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.

v) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.

vi) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Sale Proceeds of Scrap Material:

i) Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.

ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.

iii) Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.

iv) Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.

v) Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.

vi) See that scrap materials sold have been billed and check the calculations on the invoices.

vii) Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it and sold as scrap

viii) Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness

Advertisement Expenses:

i) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.
ii) See that the advertisement relates to client's business.
iii) Inspect the receipt issued by the agency.
iv) Ascertain the nature of expenditure - revenue or capital expenditure and see that it has been recorded properly.
v) Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.
vi) See that all outstanding advertisement bills have been provided for.

**Question 4**

ABC Ltd. has issued shares for cash at a premium. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

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**Solution**

Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
b) in writing off the preliminary expenses of the Company;
c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;





d) in providing for the redemption of any redeemable preference shares or of any debentures of the company; or
e) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above

**Question 5**

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices and also the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements . Explain how the auditor will verify the same. [MTP Sep'24/Nov-22 + Dec'21]

OR

CA Mehta is statutory auditor of ABC Ltd. While performing testing of additions during the year, he wanted to verify that:

i) All PPE (property, plant and equipment) are in the name of the entity he is auditing.
ii) For all additions to land and building in particular, auditor desires to have concrete about the ownership.
iii) The auditor wants to know whether entity has valid legal ownership rights over PPE, where it is kept as security for any borrowings.

Advise auditor on audit procedure to be undertaken by him to establish Rights and Obligations of entity over the PPE. [MTP Apr-23]

OR

Kyte Private Limited acquired an immovable property of substantial value during the financial year 2023-24, which is recorded in the financial statements as an addition in the Schedule of PPE. The auditor also observed that this immovable property has been mortgaged to a bank for availing credit facilities. How should the auditor verify the rights and obligations assertion for this property to ensure the entity's legal ownership and identify any charges against it? [MTP Jan'25]

**Solution**

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices.

Significance of verification

The value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts.

The auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

To verify whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.
- In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

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**Question 6**

Write the audit Procedure for verification of existence of Trade Receivables.

**Solution**

For Verification of Existence of Trade Receivables, the auditor should check the following :

i) Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. Ask for a period-end accounts receivable aging report and trace the balance as per the report to the general ledger.

ii) Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.





iii) If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

iv) A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.

v) The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

vi) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.

vii) Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include: Agreeing the balance to cash received subsequently;
Check that receivables for other than sales or services are not included in the list.

**Question 7**

MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2021-22. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to ₹ 50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeev without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect to such loans required by Schedule III to the Companies Act, 2013. What should Mr. Manik advise Mr. Viaan?

**Solution**

Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:

(a) repayable on demand or (b) without specifying any terms or period of repayment

| Type of Borrower | Amount of loan or advance in the nature of loan outstanding | Percentage to the total Loans and Advances in the nature of loans |
|---|---|---|
| Promoters | | |
| Directors | | |
| KMPs | | |
| Related Parties | | |

**Question 8**

How is "Cash and cash equivalents" disclosed in the Financial Statements as required under Schedule III (part I) to Companies Act, 2013? [Dec'21 + MTP Mar-23]

**Solution**

Disclosure of Cash & Cash Equivalent in the Financial Statements: Regarding Cash and cash equivalents. Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately

**Question 9**

Studymate Limited is a company engaged in the manufacture of stationery items. The company sells its goods on credit. The debtors as on 31.03.2024, amounted to ₹ 10 crores. What is the disclosure requirement for the company with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013?

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**Solution**

Trade Receivables ageing schedule

| Particulars | Amt (in ₹) | | | | | |
|---|---|---|---|---|---|---|
| | O/s for following periods from due date of payment # | | | | | |
| | Less than 6 months | 6 Months- 1 year | 1-2 years | 2-3 years | More than 3 years | Total |
| (i) Undisputed Trade receivables – considered good | | | | | | |
| (ii)Undisputed Trade Receivables – Considered doubtful | | | | | | |
| (iii) Disputed Trade Receivables Considered ood | | | | | | |
| iv) Disputed Trade eceivables Considered oubtful | | | | | | |





# similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of transaction.

*Unbilled dues shall be disclosed separately.*

**Question 10**

You are the statutory auditor of Jupiter Ltd. for the FY 2022-23. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?

**Solution**

Capital-Work-in Progress (CWIP)

(a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP ageing schedule

| CWIP | < 1 Year | 1-2 years | 2-3 years | > 3 years | Total |
|---|---|---|---|---|---|
| Projects in Progress | | | | | |
| Projects temporarily suspended | | | | | |

(b) For CWIP, whose completion is overdue or exceeded its cost compared to original plan, following CWIP completion schedule shall be given:

| | To be completed in: | | | | Total |
|---|---|---|---|---|---|
| CWIP | < 1 year | 1-2 years | 2-3 years | > 3 years | |
| Project 1 | | | | | |
| Project 2 | | | | | |

(Details of projects where activity has been suspended to be given separately)

**Question 11**

As the statutory auditor of Ginni Ltd., you need to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on March 31, 2024. What audit procedures should you perform to verify the company's ownership of the inventories, including items stored at third-party locations? [MTP Jan'25]

**Solution**

The statutory auditor of Ginni Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2024.

The auditor should:

- vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- evaluate the consigned goods.
- examine client correspondence, sales and receivables records, purchase documents.
- determine existence of collateral agreements.
- review consignment agreements.
- review material purchase commitment agreements.
- examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

## Past Exams/RTPs/MTPs Questions

**Question 1**

PQ & Co. want to diversify its business and for that purpose they want to raise money by issuing shares to the general public. The face value of the shares is ₹ 100 but the directors of the company propose to issue the shares at a discounted rate of ₹ 95/- so as to receive more response. The statutory auditor, however, objects to the same as it is not allowed as per the Companies Act, 2013. State the provisions of Section 53 of the Companies Act, 2013 with reference to shares issued at a discount and the consequences where the company fails to comply with the provisions of this section [May'24]

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**Solution**

Shares issued at a discount: According to Section 53 of the Companies Act, 2013,

1. a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
2. any share issued by a company at a discounted price shall be void.

Notwithstanding anything contained in above sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

Penalty

Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall





also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued

**Question 2**

What audit points are to be borne in mind in case of issue of "Sweat Equity Shares" by a limited company? [MTP Oct-19]

OR

S& Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:
(i) He noticed that some of the equity shares are held by promoters.
(ii) Some shares are issued as sweat equity shares to the employees.

What is the meaning of sweat equity shares? What are the disclosure requirements of such promoter's shareholding? [Nov-22]

**Solution**

Issue of Sweat Equity Shares: As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled-

a. The issue is authorized by a special resolution passed by the company;
b. The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
c. Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and
d. Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank paripassu with other equity shareholders.

| Disclosure Requirement | | | | |
|---|---|---|---|---|
| Shares held by promoters at the end of the year | | | | % Change during the year*** |
| S No. | Promoter Name | No. of shares | % of total shares** | |

* Promoter here means promoter as defined in the Companies Act, 2013.
** Details shall be given separately for each class of shares.
*** percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

**Question 3**

BNP Ltd has reduced its Share Capital to a greater extent in the year for which you are conducting the audit. State how will you proceed for verifying the reduction of Capital. [MTP Oct-20]

**Solution**

Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

i) Verify that meeting of shareholders held to pass special resolution was properly convened and that proposal was circularized in advance to all the shareholders;
ii) Verify that the Articles of Association authorises reduction of capital;
iii) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;
iv) Check the Registrar's Certificate as regards to reduction of capital;
v) Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;
vi) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.
vii) Verify that the Memorandum of Association of the company has been suitably amended.

**Question 4**

Reserves are a vital source of financing by internal means. Explain and also discuss the meaning of reserves along with revenue reserve and capital reserve. [MTP Oct-22]

**Solution**

Reserves are the amounts appropriated out of profits that are not intended

- to meet any liability,
- contingency,
- commitment or
- diminution in the value of assets known to exist as at the date of the Balance Sheet.



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Reserves are a vital source of financing by internal means. They are held for the purpose of distribution of dividend or financing the expansion of the company or strengthening the company financially. The company utilizes the reserves according to the nature and type of such reserve.

The reserves can be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:
To supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

Example
Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

**Question 5**

The financial statements of XYZ Limited show long-term borrowings from the banks, financial institutions, leasing, and hire purchase companies. Additionally, the company has issued debentures to its 1000 members to raise funds in accordance with the provisions of the Companies Act, 2013. The money raised by issuing debentures is also reflected in long-term borrowings. As the statutory auditor of XYZ Limited, CA X wants to verify that all borrowings on the balance sheet represent valid claims by banks or other third parties. Suggest a few audit procedures in this regard. [MTP Sep'24]

**Solution**

The audit procedures required to be undertaken by CA X while auditing borrowings is as follows:

- Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments are approved by the board of directors.
- Check the details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by the agreements are not exceeded.
- Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).

- Verify the details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders

**Question 6**

Alfa Limited has availed bank overdraft facility from a nationalized bank. The company received balance confirmation certificate for bank overdraft balance as on 31.03.2024 from the bank.

| Particulars | Amount (₹) |
|---|---|
| Bank overdraft balance as per Bank Certificate | 25,66,200/- |
| Bank overdraft balance as per Ledger | 26,45,300/- |

How will you vouch/verify borrowings from Bank taken by Alfa Limited?

[Sep'24]

**Solution**

Vouching /Verification of borrowings from Bank:

The auditor is required to roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following:

- Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests).
- Send reminders for non-replies.
- Compare the balances as per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.
- Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last-mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.



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- Ascertain the ... and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Question 7**

M/s Veer and Associates is appointed as auditor of KMP limited. During the audit, auditor wants to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. Which assertion auditor wants to ensure and what audit procedures should be followed by him in this regard? [MTP Sep'24]

**Solution**

Auditor wants to ensure Completeness assertion.

- Auditor needs to perform following cut off procedures:
  - ✓ For last 5 invoices received/ recorded at end of reporting date (cut off date) & which have been included in trade payables; goods should have been received/ risk & rewards of ownership in goods should have been transferred in favour of entity;
  - ✓ All goods received prior to period/ year- end should have been booked in form of purchases & included in trade creditors.
- Test purchases/ expenses on a sample basis selecting same from accounts payable ledgers & checking their supporting documents to ensure that the purchases were recorded at the correct amounts & correct dates.
- Match purchase invoice dates to gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
- Review subsequent expense vouchers. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.
- For advance received from customers/ revenue received in advance, obtain customer wise listing along with its ageing & nature. Enquire from entity's management if there has been any dispute with customer and if there is any additional liability to be recorded. For all such advances, auditor should verify underlying documentation based on which the entity had received the advance.
- In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses.

  Example-
  - ✓ GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

- ✓ Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- ✓ Further, obtain & verify challans for deposits made subsequent to period-end for all statutory liabilities as at the balance sheet date & also analyse reasons, if any, in consultation with the management for any variance between amounts deposited subsequently vis-à-vis liability recorded in books of account.
- He shall prepare a complete list of all statutory dues & consider his reporting requirements under CARO,2020.

**Question 8**

The management of D. Ltd. have engaged an actuary-expert to ascertain actuarial valuation of gratuity for provision to be made in the accounts. As an auditor of D. Ltd., you plan to use the report of the said expert as audit evidence for ascertaining appropriate valuation of provisions. As an auditor, what will you do to evaluate the competence, capabilities, objectivity and an understanding of the work of the actuary-expert who has carried out actuarial valuation of gratuity? [Sep'24]

**Solution**

As per SA 500, "Audit Evidence", issued by ICAI, when using the work of a management's expert as audit evidence the auditor should evaluate the competence, capabilities and objectivity of that expert that:

- Whether the expert is employed by the entity or is an outside party.
- Whether the expert is independent in respect of the entity
- Auditor's previous experience of the work of the expert.
- Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.

The auditor should also obtain an understanding of the work of that expert that:

- Whether the auditor has expertise to evaluate the work of the expert.
- Evaluating the assumptions and methods used by the management.
- Evaluating the nature of internal or external data used by the expert.

**Question 9**

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statements as required by AS 29. What type of disclosures should be made for each class of contingent liability as at the balance sheet date? [MTP Mar-21]



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**Solution**

Disclosure for each class of Contingent Liability: From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

i) A brief description of the nature of the contingent liability and where practicable.
ii) An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
iii) Indication of the uncertainty relating to outflow.
iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

**Question 10**

HR & Associates are the auditors of a large manufacturing company. The company has recently invested huge amount in Property, Plant and Equipment (PPE) for its new unit. They have added many incidental expenses to the cost of PPE. The junior audit team members are not sure about which costs should be excluded from the cost of PPE. Give examples of costs that should not form part of costs of PPE. [May'24]

**Solution**

Examples of costs that are not costs of an item of property, plant and equipment are:

i) costs of opening a new facility or business, such as, inauguration costs;
ii) costs of introducing a new product or service (including costs of advertising and promotional activities);
iii) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
iv) administration and other general overhead costs.

**Question 11**

JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment during the year under audit. They have incurred an amount of ₹ 5,70,000/- on dismantling of an old plant, which had become obsolete, so that a new plant can be set up at the existing location. The Auditor is in the process of verifying the cost incurred towards addition to Property, Plant and Equipment. What should be the accounting treatment of the amount spent on dismantling of old plant in the financial statements? Which elements of cost should be considered for valuing Property, Plant and Equipment? [Sep'24]

**Solution**

In the given situation, JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment and incurred an amount of ₹ 5,70,000 on dismantling of old plant which had become obsolete so that new plant can be set up at the existing location.

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost. The costs of dismantling, removing the item and restoring the site on which it is located referred to as decommissioning will form part of the new Property, Plant and Equipment.

Elements of Cost: The cost of an item of property, plant and equipment comprises:

i) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
ii) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
iii) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

**Question 12**

You are an auditor of PQR Ltd. which has spent ₹ 50 lakhs on Research activities of the product during period under audit, Board of Directors want to recognize it as an internally generated intangible assets. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements. [MTP Nov-20/Apr-23]

**Solution**

No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

i) the said asset is identifiable;
ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;
iii) it is probable that future economic benefits associated with the asset will flow to the entity;
iv) the cost of the item can be measured reliably.

**Question 13**

CA Karan wants to test the "completeness" assertion relating to intangible assets reflected in the financial statements of Data Solutions Private Limited. State audit procedures to be performed by CA Karan in this regard. [MTP Jan'25/Sep'22]



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**Solution**

1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions - Deletions = Closing balances. Tally the closing balances to the entity's books of account.
2. Check the arithmetical accuracy of the movement in intangible assets schedule.

For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:

i) For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
ii) Ensure that no cost related to research (or from the research phase of an internal project) gets recognized as intangible asset.
iii) Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
iv) Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
v) Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.
vi) In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

**Question 14**

The value of intangible assets may diminish due to efflux of time, use and/or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Discuss the audit procedures to be applied by the auditor to ensure that Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices. [July-21]

**Solution**

The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts.

The auditor should:

- ✓ Verify that the entity has charged amortization on all intangible assets;
- ✓ Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- ✓ Auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.

**Question 15**

It is important to carry out the Tests of Controls for checking effectiveness of internal control over sales as a part of the debtors' audit procedure. In above context, state the points which need to be considered in respect of trade receivables. [MTP II May'24]

**Solution**

It is important to carry out Tests of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure.

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Following points need to be considered in respect of trade receivables:

- Only bona fide sales lead to trade receivables.
- All such sales are made to approved customers.
- All such sales are properly recorded in the books of accounts.
- Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
- Debtors are collected on time.
- In case debtors are not collected in time, sending reminders and taking legal actions if required.
- Balances are regularly reviewed.
- A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors

**Question 16**

While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books of accounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded have been recognized in the financial statements. How will you achieve the stated objective? [Nov-22]





**Solution**

Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): The auditor needs to satisfy himself of the cut-offs.

Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

a. For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;
b. Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;
c. Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

**Question 17**

CA J is appointed as statutory auditor of Sigma and Beta Limited for the year 2023-24. During the audit he observed trade receivables amounting to ₹ 50 crores are reflected in the financial statements of the company. He wants to obtain sufficient appropriate evidence to conclude that trade receivables have been valued appropriately. Suggest few audit procedures in this regard. (MTP II Sep'24)

**Solution**

1. Review the process followed by Co. to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, & a determination of whether method is appropriate for the underlying business environment.
2. Obtain the ageing report of accounts receivable (both Dr/Cr balance).
3. Also, obtain the list of debtors under litigation and compare with previous year.
4. Scrutinize the analysis & identify those debtors which appear doubtful; discuss management about reasons as to why these debtors are not included in provision for bad debts. Perform further testing where any disputes exist.
5. He should check if provisions are made at appropriate rates considering the recoverability of amounts due.
6. Prepare schedule of movements of bad debts – Provision accounts & debts written off & compare proportion of bad debt expense to sales for current year in comparison to prior years to see if current expense appears reasonable.
7. Check that write-offs of receivable balances have been approved by an appropriate authority i.e. Board of Directors in case of a company.

**Question 18**

ABC & Co. are in the business of manufacturing toys. The stock taking process has been done by the company as on 31.3.2024. The company has used FIFO method for valuation of its inventories. The cost of inventory as on 31.3.24 is ₹ 25,25,000/- and the net realizable value of the inventory on the same date is ₹ 25,24,000/-.

The cost of inventory includes the following:

(1) Material purchase cost - ₹ 25,05,000/-

(2) Allocated transport cost - ₹ 18,000/-

(3) Abnormal wastage - ₹ 2,000/-

The management seeks your advice in arriving at the value of inventory to be shown in the financial statements of the company. What should be the value of inventory in accordance with AS-2? [May'24]

**Solution**

Value of Inventory: Inventory to be recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Further, any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (e.g. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

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In the given situation, ABC & Co. is using FIFO method for valuation of its inventories. Further, cost of inventory as on 31.03.2024 is rupees 25,25,000 which includes material purchase cost of rupees 25,05,000, allocated cost of transport of rupees 18,000 and abnormal wastage of rupees 2,000. Net realizable value of said inventory is ₹ 25,24,000.

In view of provisions of AS 2, cost allocated to transport for inventory is relating to bringing the inventory to the location, thus it will be added in cost of material. However, abnormal wastage of rupees 2000 should be excluded from cost of inventory.

Thus, cost of inventory will be ₹ 25,25,000 - ₹ 2,000 = 25,23,000 rupees and Net realizable value of inventory is ₹ 25,24,000.

For valuation in accordance with AS 2, "Inventory", lower of cost and net realizable value will be considered. Accordingly, ₹ 25,23,000 to be considered as value of inventory in the given situation.

**Question 19**

Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and do not include any inventories that belong to third parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance. [MTP Sep'24]





**Solution**

Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -

- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
  - Compute inventory turnover ratio (COGS/ average inventory)
  - Perform vertical analysis (inventory/ total assets)
  - Compare budgetary expectations vis-à-vis actuals
- Examine non-financial information related to inventory, such as weights and other measurements.
- Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- Verify the clerical and arithmetical accuracy of inventory listings.
- Reconcile physical inventory amounts with perpetual records.
- Reconcile physical counts with ledger control totals.
- Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- Goods received on a consignment basis have been properly segregated from other items of inventory.

**Question 20**

Being statutory auditor of JAL Limited, a company engaged in manufacturing of chemicals, CA Gopika has understood that company is expected to have material work-in-progress as on 31st March, 2024. State few audit procedures to verify existence and valuation assertions for work-in-progress. [RTP May'24 + Jan'21]

**Solution**

Existence

- Attend inventory count in accordance with SA 501 and understand how work in progress is arrive at.
- Evaluate work of management expert, if any, in this regard.

Valuation

- Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- Ensure that material costs exclude any abnormal wastage factors.

**Question 21**

Write the audit procedures to be performed as an auditor for valuation (assertion) of Finished goods and goods for resale. [MTP May-20]

**Solution**

Audit procedure for valuation of finished goods and goods for resale

- Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.
- Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-385 days old and more than 365 days old (refer screenshot below).
- Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete.
- Compare recorded costs with replacement costs. Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles.

**Question 22**

During the audit of Rapid Industries Private Limited, CA Akshat notices that inventories of raw materials & consumables and work-in- progress amounting ₹ 2.50 crores and ₹ 0.25 crores appear in the financial statements of the company as on March 31st, 2024. He wants to verify that the above-mentioned inventories have been valued appropriately and as per generally accepted accounting policies and practices. How should he proceed to verify the above? [May'23]



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**Solution**

For Raw materials and consumables:

- Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.
- If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analysed and accounted for/ treated in accounting records.
- Test check cost prices used with purchase invoices received in the month(s) prior to counting.
- Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

For Work in Progress: [Discussed in Q14]

**Question 23**

A significant and important audit activity is to contact banks/ financial institution s directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context. [RTP Nov-20]

**Solution**

Direct confirmation procedure

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances.

In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances.

This testing could include:

- ✓ Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
- ✓ Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

**Question 24**

While verifying cash and cash equivalents of a company, CA D engagement partner, is very particular that Bank reconciliation statement (BRS) prepared by the management in respect of bank account maintained by the company is proper to rule out misstatements in cash and cash equivalents reflected in the financial statements of the company. The company does not use net banking and prefers to issue

cheques to its creditors and receives substantial [illegible] payee cheques. What aspects need to be taken care of and verified by CA D in respect of BRS? [MTP May'24]

**Solution**

CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

Verification of BRS shall entail the following: -

- Tallying the balance as per bank book to the bank confirmation/ statement.
- Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
- Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

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**Question 25**

Write the audit procedures to be performed as an auditor for valuation (assertion) of Loans and Advances and other current assets. [MTP May-20]

**Solution**

Audit procedure for valuation of Loans and Advances and other current assets

- Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60-180 days old, 180-365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.





- Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances - Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions in the recoverable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

**Question 26**

WTE Private Limited is engaged in business of manufacturing a product liable to GST @ 5%. The input raw materials for manufacturing this product are liable to GST @ 12% and 18%. As a result, at the end of financial year, ITC on inputs amounting to ₹ 60 lacs is accumulated in Electronic Credit ledger and refundable to company under provisions of GST law. How would above amount of ₹ 60 lacs be reflected and classified in balance sheet of company? State few audit procedures to be performed by you for verification of abovesaid balance. [MTP May'24]

**Solution**

In the given situation, ₹ 60 lacs is accumulated in Electronic credit ledger of WTE Private Limited as finished product is liable to lower GST rate whereas input raw materials for manufacturing carry higher GST rate. It is refundable to company by virtue of provisions of GST law. The above 8 balance would be reflected and classified under current assets. Within current assets, it would be classified into "Other current assets".

Few audit procedures to be performed for verification of above balance are:

- In relation to balances with statutory authorities like GST input credit, prepare a reasonability analysis with respect to purchases by applying the applicable rate to the purchases and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.
- Obtain copies of statutory GST returns filed on GST portal.
- In case refundable amount as on balance sheet date is still outstanding, verify whether the amount recorded as per books of account tallies with the claim made with the authorities subsequently by going to GST portal.
- In case refundable amount as on balance sheet date is received subsequently, verify it from Bank statement.

**Question 27**

CA "X" while conducting an audit of Joyful Ltd. found a considerable increase in sales as compared to the previous year, he doubts that few fictitious sales have been recorded by the company to overstate its revenues. Discuss any four audit procedures to be undertaken by the auditor to ensure revenue from sales of goods and services performed during the period is not overstated? [July-21 + MTP May'24]

**Solution**

CA X, having doubts about fictitious sales being recorded by Joyful Ltd would ensure that revenue is not overstated by performing following audit procedures:

- Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
- Test check few invoices with their relevant entries in sales journal.
- Obtain confirmation from few customers to ensure genuineness of sales transaction
- Whether any fictitious customers and sales have been recorded.
- Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
- Whether unearned revenue recorded as earned.
- Whether any substantial uncertainty exists about collectability
- Whether customer obligations are contingent on other actions (financing, resale etc.)

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**Question 28**

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. Explain the audit procedures to ensure the same. [MTP Nov-22]

**Solution**

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. The auditor can perform the following procedures to ensure the same.

- Trace a few transactions from inception to completion. (Examination in depth)
  E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.





- Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

**Question 29**

Auditor of ABC Ltd while auditing its financial statements wants to ensure whether the disclosures regarding sales has been made as required under Schedule III (Part 1) to Companies Act, 2013. Explain such disclosure requirements. [MTP Mar-21]

**Solution**

With respect to sales of the client entity, the auditor is required to ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

- Whether disclosure of sales in respect of each class of goods has been made.
- Whether revenue from operations is disclosed separately in the notes as revenue arising from:
  - ✓ Sale of products (including excise duty)
  - ✓ Sale of services
  - ✓ Other operating revenues.
- Whether brokerage and discount on sales other than usual trade discount has been disclosed.
- Whether the transactions with related parties are appropriately disclosed in notes to accounts.

**Question 30**

As a Statutory Auditor of the company list out audit procedure required to be undertaken for the recognition of following other income:

i. Interest income from fixed deposit

ii. Dividend income

iii. Gain/(loss) on sale of investment in mutual funds. [Jan-21]

**Solution**

Statutory auditor would perform the following audit procedure for recognition of different items given in the question:

(1) Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

(2) Dividends are recognised in the statement of profit and loss only when:

i) the entity's right to receive payment of the dividend is established;

ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

iii) the amount of the dividend can be measured reliably.

(3) Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

**Question 31**

ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2019-20. CA X, partner of XYZ & Company, was looking after the audit of other income of the company which consists of interest income on fixed deposits. As a Statutory Auditor how would CA X verify interest income on fixed deposits for the year 2019-20? [Nov-20]

**Solution**

CA X, partner of XYZ & Company, would carry out the following audit procedure for verifying interest income on fixed deposits of ABC Limited:

- Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
- For deposits still outstanding as at the period-end, trace the same to the direct confirmations obtained from the respective banks/ financial institution.
- Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
- Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

**Question 32**

XY and Associates are auditors of PQR Ltd., which provides electrical components on project basis. The purchases are huge and the auditor wants to make sure that all the purchases made during the period are recorded and there is no understatement or overstatement. For this purpose the audit team have performed procedures like cut-off tests, correct treatment of goods in transit, obtaining written representations and performing analytical procedures. What are the analytical procedures required to be performed to obtain audit evidence as to overall reasonableness of purchase quantity and price?

**Solution** [RTP May-23 + May'24]

Auditor needs to perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

i) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management if any significant variations found.



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ii) Stock Composition: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.

iii) Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

**Question 33**

Explain how you would verify Employee Benefit Expense incurred by a Company. [MTP Oct-22]

**Solution**

The auditor shall verify that:

i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.

ii) Employee benefit expenses in respect of all personnel have been fully accounted for.

iii) Employee benefit expenses recognized during the period relates to the current accounting period only.

iv) Employee benefit expense has been measured/ calculated accurately. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.

**Question 34**

Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortisation expense. [Jan-21]

**Solution**

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.

- Whether the most appropriate depreciation method for each separately depreciable component has been used.

**Question 35**

Profit and Loss account of an organization shows various types of expenses like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations. What are the attributes that an auditor generally prefers for vouching these types of expenses? [Dec-21 +MTP Oct-21 + Nov-22]

**Solution**

Attributes to be preferred for vouching other expenses:

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

i) Whether the expenditure pertained to current period under audit;
ii) Whether the expenditure qualified as a revenue and not capital expenditure;
iii) Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
iv) Whether the expenditure has been classified under the correct expense head;
v) Whether the expenditure was authorised as per the delegation of authority matrix;
vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

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**Question 36**

The auditor may choose to analyse the monthly trend for Power & Fuel expense. Explain how this analysis will be performed by the auditor [MTP Nov-21]

**Solution**

Power and fuel expense -

- Obtain a month wise expense schedule along with the power bills.
- Verify if expense has been recorded for all 12 months.
- Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
- In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

**Question 37**

Explain how you would verify rent expense incurred by a Company. [MTP Nov-22]

**Solution**

Rent expense can be verified by:





- Obtaining a month wise expense schedule along with the rent agreements.
- Verifying if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
- Giving specific consideration to the escalation clause in the agreement to verify if the rent was required to be recorded on a straightline basis during the period under audit.
- Also, verifying if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity

**Question 38**

While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform? (MTP Mar-23)

**Solution**

While verifying legal and professional expenses of client company, auditor should perform following audit procedures

- Obtain a month-wise and consultant-wise summary.
- In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly.
- For non- recurring expenses, select a sample and vouch for the attributes discussed above.
- Auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which entity may not have made any provision and matter may also not have been discussed/ highlighted to auditor for his specific consideration

**Question 39**

Prudent Enterprises Private Limited has incurred and fully spent for the first time Corporate Social Responsibility (CSR) expenditure amounting to ₹ 14.50 lacs in pursuance to provisions of section 135 of Companies Act, 2013. The expenditure was spent for women empowerment programmes through an implementing agency (not a related party). As per law provisions, it was required to spend ₹ 14.00 lacs during the year. Discuss how such information is required to be disclosed in accordance with requirements of Schedule III to the Companies Act, 2013 in financial statements of the company.

[MTP-1 May'24/23 + May-22]

**Solution**

In the given situation, following information is required to be disclosed in accordance with requirements to Schedule III to the Companies Act, 2013:

| S No. | Details | Amount (₹'lacs) |
|---|---|---|
| a | amount required to be spent by the company during the year | 14 |
| b | amount of expenditure incurred | 14.50 |
| c | shortfall at the end of the year | NIL |
| d | total of previous years shortfall | NA |

| | | |
|---|---|---|
| e | reason for shortfall | NA |
| f | nature of CSR activities - Women empowerment activities through implementing agency | |
| g | details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard | NIL |
| h | where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately | NIL |

**Question 40**

Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings? [May-22 +MTP May-22]

**Solution**

Disclosure in case of Benami Properties held by the Company: Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:

a. Details of such property, including year of acquisition,
b. Amount thereof,
c. Details of Beneficiaries,
d. If property is not in the books, then the fact shall be stated with reasons,
e. Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor, then the details shall be provided,
f. Nature of proceedings, status of same and company's view on same.

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**Question 41**

ollowing is extract of notes to accounts of financial statements of STU Private Limited listing some atios. Discuss, whether disclosure, given in following manner meets requirements of Schedule III of e Companies Act, 2013. Ignore other ratios which are not listed in extract given below:

| lame of Ratio | 31.03.23 | 31.03.22 |
|---|---|---|
| urrent Ratio | 2.50 | 2.30 |
| ventory Turnover Ratio | 3.00 | 6.00 |
| ade receivable turnover ratio | 1.75 | 5.00 |
| t profit ratio | 13% | 10% |

May'24]





**Solution**

Disclosure given in question doesn't meet requirements of Schedule III to Companies Act, 2013. Schedule III requires that the company shall explain items included in numerator & denominator for computing ratios. Further explanation for any change in ratio by more than 25% compared to preceding year.

In given table, Co. has not explained the items included in numerator and denominator for computing ratios.

Further, variations in ratios as compared to preceding year are as under: -

| Name of Ratio | 31.03.23 | 31.03.22 | Variation |
|---|---|---|---|
| Current Ratio | 2.50 | 2.30 | 8.69% |
| Inventory Turnover Ratio | 3.00 | 6.00 | 50% |
| Trade receivable turnover ratio | 1.75 | 5.00 | 65% |
| Net profit ratio | 13% | 10% | 30% |

As calculated above, there is change in inventory turnover ratio, trade receivables turnover ratio and net profit ratio by more than 25% as compared to preceding year. Therefore, explanations for such changes have also to be provided where there are changes by more than 25% as compared to preceding year.

**Question 42**

Schedule III of the Companies Act, 2013 prescribes disclosure of certain ratios as a part of Additional Regulatory Information. Mention any 3 ratios that should be disclosed along with the Rules relating to disclosure of these ratios. [Sep'24]

**Solution**

Disclosure of Ratios as a part of Additional Regulatory Information as per Schedule III of the Companies Act 2013 and its Rules relating to disclosure are:

1. Current Ratio,
2. Debt-Equity Ratio,
3. Debt Service Coverage Ratio,
4. Return on Equity Ratio,
5. Inventory turnover ratio,
6. Trade Receivables turnover ratio,
7. Trade payables turnover ratio,
8. Net capital turnover ratio,
9. Net profit ratio,
10. Return on Capital employed,
11. Return on investment.

Rules relating to disclosures of Ratios:

- The company shall explain the items included in the numerator and denominator for computing the above ratios.
- Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

**Question 43**

A Ltd. has traded for ₹ 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021-2022 and earned a profit of ₹ 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company ? [Nov-22]

**Solution**

Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

a. profit or loss on transactions involving Crypto currency or Virtual Currency
b. amount of currency held as at the reporting date,
c. deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency

**Question 44**

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Tisa Industries Private Limited has prepared its financial statements for year 2023-24.

The financial statements and notes to accounts show following information and disclosure in respect of trade receivables of the company: -

| S No | Particulars | Amount ( ₹ in lacs) |
|---|---|---|
| 1. | Trade Receivables | 240.00 |

Trade receivables ageing schedule. Outstandings for following periods from due date of payment

| Particulars | Less than 1 year | 1-2 years | 2-3 years | More than 3 years | Total |
|---|---|---|---|---|---|
| MSME | 150.00 | 30.00 | 10.00 | XXX | 190.00 |
| Others | 40.00 | XXX | XXX | XXX | 40.00 |
| Disputed dues-MSME | XXX | XXX | XXX | XXX | XXX |
| Disputed dues-others | 10.00 | XXX | XXX | XXX | 10.00 |





you are part of engagement team conducting audit of the company. Point out discrepancies including omissions in above disclosure. (Do not prepare another table) [MTP May'24]

**Solution**

The above disclosure is not in accordance with requirements of Division I of Schedule III of Companies Act, 2013.

The discrepancies are as under: -

(1) The Company has wrongly disclosed information for trade receivables in a manner which is applicable for trade payables.

(2) No distinction between MSME and other trade receivables is required.

(3) Trade receivables are to be categorised into undisputed and disputed trade receivables as under: -

- Undisputed trade receivables considered good
- Undisputed trade receivables considered doubtful
- Disputed trade receivables considered good
- Disputed trade receivables considered doubtful

(4) Aging is to be reflected for each of above categories in respect of outstandings for the following periods from due date of payment

- for less than 6 months
- 6 months-1 year
- 1- 2 years
- 2-3 years
- more than 3 years

(5) Following information is also required to be disclosed: -

Trade receivables shall be sub-classified as:

a) Secured, considered good
b) Unsecured, considered good
c) Doubtful.

(6) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(7) Debts due by

- directors or other officers of the company or any of them either severally or jointly with other person or

- firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

**Question 45**

Droma Shoes Private Limited was established in year 2022-23 for manufacturing of footwear. As funds were needed to carry on its business activities - including for purchase of different raw materials, incurring of regular expenses like power and fuel and payment of wages etc., it had got sanctioned a credit facility amounting to ₹ 2 crores repayable on demand from a bank against primary security of its current assets and collateral security of residential house of one of its directors. Duly signed guarantee documents by directors in favour of bank also form part of bank's loan documentation.
Account statement of above facility downloaded from bank's website shows debit balance of ₹ 1.85 crores as on 31st March, 2023. The operations in above credit facility are satisfactory.
In this regard: -

i) Identify nomenclature of such credit facility given by banks. How would above amount of ₹ 1.85 crores be reflected and classified in financial statements of company as on 31.3.23?
ii) Also state specific disclosure requirements of Schedule III of Companies Act, 2013 in relation to above. [RTP May'24]

**Solution**

i) Type of credit facilities referred in above situation given by banks to meet working capital requirements of business which are repayable on demand are known as "cash credit facilities/overdraft" facilities.

Amount of ₹1.85 crores outstanding as on 31.3.23 reflects borrowings of Co. and classified as "short-term borrowings" as loans repayable on demand from banks under current liabilities in balance sheet of Co. Borrowings shall further be subclassified as secured.

ii) Specific disclosure requirements of short-term borrowings under Schedule III to Companies Act, 2013 in given situation are as under: -

- Nature of security i.e. primary security of current assets & collateral security of residential house belonging to a director shall be specified.
- As loans have been guaranteed by directors, aggregate amount of such loans shall be disclosed.

To be disclosed as Additional Regulatory Information
Since Co. has borrowings from bank on basis of security of current assets, it shall also disclose following:-

a) whether quarterly returns or statements of current assets filed by Co. with banks or financial institutions in agreement with books of accounts.
b) if not, summary of reconciliation & reasons of material discrepancies, if any to be adequately disclosed.

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**Question 46**

M/s. Ltd. has given below loans to the following borrowers during the financial year 2023-24. Mr. B an auditor wants your guidance regarding additional regulatory information required to be provided under the Companies Act, 2013:

| Borrowers | Maximum Loan granted during the year 2023-2024 (₹ in Lakh) | Outstanding Loan as at 31/03/2024 (₹ in Lakh) |
|---|---|---|
| X (Promoter) | 20 | 15 |
| Y (Director) | 30 | 25 |
| Z (KMP) | 10 | 05 |
| A (Related Party) | 20 | 10 |
| Others | 80 | 25 |
| Total | 160 | 120 |

[May'24]

**Solution**

As additional regulatory requirements, following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person, that are:

(a) repayable on demand or
(b) without specifying any terms or period of repayment.

| Type of Borrower | Amount of loan or advance in the nature of loan outstanding (₹ In Lakhs) | Percentage to the total Loans and Advances in the nature of loans (₹ in Lakhs) |
|---|---|---|
| X (Promoter) | 15 | 12.5% =15/120 X 100 |
| Y (Director) | 25 | 20.833% =25/120 X 100 |
| Z (KMP) | 05 | 4.167% =5/120 X 100 |
| A (Related Party) | 10 | 8.333% =10/120 X 100 |

*"Be a Warrior not a Worrier"*

**Question 1**

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

**Solution**

One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

**Question 2**

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

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**Solution**

In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

**MCQs**

**1. Which of the following is not one of functions of internal auditor of an organization?**

(a) Performing assurance activities

(b) Performing consulting activities to improve governance of organization

(c) Performing risk management activities

**(d) Expressing independent opinion on financial statements of organization**





**Question 1**

Discuss some of circumstances when work of the internal auditor cannot be used by external auditor. [SM]

**Solution**

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

b) The function lacks sufficient competence; or

c) The function does not apply a systematic and disciplined approach, including quality control.

**Question 2**

M/s PSR & Associates are the auditors of The Saturn Hotel, a chain of fivestar hotels. Since the nature of their business is prone to frauds, the company has appointed internal auditors at various locations. The company has also devised a system of effective and efficient internal controls. The auditors, M/s PSR & Associates, want to use the work of the internal auditors. In order to ensure effectiveness, what kind of coordination should be there between the external auditor and the internal audit function? [May'24]

**Solution**

As per SA 610, "Using the Work of Internal Auditors", coordination between the external auditor and the internal audit function is effective when, for example;

i) Discussions take place at appropriate intervals throughout the period.

ii) The external auditor informs the internal audit function of significant matters that may affect the function.

iii) The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

**Question 3**

CA Mukul is the external auditor of Beige Ltd., a large company, engaged in the manufacturing of fast-moving consumer (FMCG) goods. After assessing the internal audit function of the company, CA Mukul decided to use the internal auditor of the company to provide direct assistance. In this context, what is meant by direct assistance under relevant Standard on Auditing? Also comment whether prior to using internal auditor for direct assistance for the purpose of audit, CA Mukul is required to obtain any written agreements or not. Give examples of procedures in which CA Mukul shall not use an internal auditor to provide direct assistance. [RTP Jan'25]

**Solution**

As per SA 610, "Using the work of Internal Auditor", direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Prior to using internal auditors to provide direct assistance for purposes of the audit, CA Mukul, the external auditor shall: -

a. Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and
b. Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

a. Procedures which involve making significant judgments in the audit;
b. Procedures relat ng to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.
c. Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
d. Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

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**Question 4**

CA Z is appointed as statutory auditor of BETA Private Limited for the year 2023-24. There exists an internal audit function in the company headed by its Chief Internal Auditor, CA K. Valuation of trade receivables of company is assessed as area of higher risk by statutory auditor. He wants to take direct assistance of Chief Internal Auditor in respect of above matter.

Discuss along with reasons whether it would be proper for statutory auditor to: -

i) assign checking of accuracy of aging of trade receivables to Chief Internal Auditor?
ii) assign evaluation of adequacy of provision based on aging of trade receivables to Chief Internal Auditor? [MTP I May'24]

**Solution**

In accordance with SA 610, the external auditor shall not use internal auditors to provide direct assistance to perform procedures that relate to higher assessed risks of material misstatement where





the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

In the given situation, valuation of trade receivables is assigned as an area of higher risk by statutory auditor. Judgment required in checking of accuracy of aging of trade receivables is limited. Therefore, external auditor can assign the checking of the accuracy of the aging to Chief Internal Auditor providing direct assistance as it involves limited judgment.

However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to Chief Internal Auditor providing direct assistance.